Consolidated Financial Statements

2011

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Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. for the financial year 2011 include the Bank and its subsidiaries (collectively referred to as the "Group").

Landsbankinn was founded by the Ministry of Finance on 7 October 2008. The Group offers a complete range of financial products and services for personal, corporate and institutional customers. The number of full-time equivalent position was 1311 at year-end.

Landsbankinn is currently owned by two entities: Landsskil, which is owned by Landsbanki Íslands hf. and wields 18.7% of voting rights; and Icelandic State Financial Investments (ISFI), which wields 81.3% of voting rights.

Operations in 2011

Consolidated profit amounted to ISK 16,957 million for the financial year 2011. The Board of Directors proposes that no dividends will be paid in 2012 and that the profits of 2011 to be added to equity. Consolidated total equity amounted to ISK 200,244 million at the end of the year, including share capital amounting to ISK 24,000 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 21.4% at year-end 2011.

In 2011, the Group finalised the sale of its 100% holding in the subsidiary Eignarhaldsfélagið Vestia ehf. (Vestia) and its 100% holding in Icelandic Group hf.

The Bank took over the operations of SpKef Savings Bank as of 7 March 2011 in accordance with a decision made by the Financial Supervisory Authority (FME). The activities and operations of SpKef have been fully integrated into Landsbankinn. The consideration payable by the National Treasury, through a bond to be issued to the Bank, is subject to a ruling of an arbitrage committee on the eventual fair value of financial assets acquired and liabilities assumed.

In March 2011, the Group completed the acquisition of all shares in the company Rose Invest hf. and changed the name to Landsbréf hf. This subsidiary will manage UCITS (Undertakings for Collective Investment in Transferable Securities) and other funds for collective investment and investment advice.

The Group's merger with two of its subsidiaries, SP-Fjármögnun hf. and Avant hf., was finalised in October. Their principal business operation was vehicle leasing and lending services. The objective of the merger was primarily to streamline operations and offer customers of Landsbankinn a wider range of products and more comprehensive services.

In 2010 and 2011 the Supreme Court of Iceland delivered rulings on the illegality of provisions of currency-indexation in loan agreements. In accordance with law, such loans should bear the lowest interest rates of un-indexed loans denominated in Icelandic krona as calculated by the Central Bank. An impact of these rulings was recognized in the consolidated financial statements of the Group as at 31 December 2010. Additionally, in the fourth quarter of 2011 an expense amount of ISK 2.7 billion was recognized in the consolidated income statement of the Group as a result of recalculations of loans subject to this ruling.

On 15 February 2012 the Supreme Court ruled that a lender could not apply the Central Bank interest rates under circumstances specified in the ruling, inter alia, as the lender had issued final receipt of payment. The case did not involve any Group entity but may be of relevance for the Group. The precedent set by this new ruling is not clear when these consolidated financial statements are authorised for issue. However, the Group has accounted for the potential impact of this new ruling in the consolidated financial statements for the Group for the year ended 31 December 2011, based on management's current best estimate. More Court rulings are needed to get a clarification of the precedence and therefore the total amount of the estimated impact might change accordingly.

Outlook

The Icelandic economy bounced back from a two year recession in 2011 with an estimated 3.1% growth in real gross domestic product (GDP). The outlook for the domestic economy remains uncertain in the coming year, partly due to economic uncertainty in Iceland´s main export markets and persistent high inflation. Despite this, economic indicators show that growth can be expected to continue in 2012.

Due to restrictions on movement of capital between Iceland and other countries the Group has limited ability to mitigate the risk from ISK related currency fluctuations. However, the Group has taken various measures to decrease its overall currency risk and expects future currency risk levels to be within acceptable limits.

Reginn hf. and Horn fjárfestingarfélag hf. are subsidiaries of the Bank. Reginn hf. manages the Group's long-term holdings in real estate. Horn fjárfestingarfélag hf. is an investment company with holdings in listed and unlisted equities in a wide variety of industrial sectors. Both companies and their assets will be offered for sale in 2012.

Core operations of Landsbankinn are sound and continuously improving. Foundations in the form of revised and new processes have been laid to improve efficiency and customer relationship management. The Group has a strong equity and liquidity base and is, therefore, in a strong position to deal with challenges ahead, and become a force for change in the Icelandic economy.

Risk Management

It is the view of the Board of Directors of Landsbankinn that efficient risk management is a strategic tool to enhance value generation. Internal controls should ensure effective operations and prudent management of risks that could otherwise prevent the Group from attaining its business targets.

The Group has continued to improve its risk management framework and policies in 2011, in line with international best practices, and has defined its risk appetite. The Group aims to strengthen further its risk management processes and enhance the risk culture in the coming year. Further description of the Group's risk management is provided in Notes 43-80.

According to legislation passed in 2009 the salary of the CEO of Landsbankinn is determined by the Compensation Council ("Kjararáð"). The Council determines remuneration and terms of employment of high level government employees and CEOs of companies in which the government holds a majority of shares. It is of great concern to the Board that Kjararáð's decision leaves the salary of the CEO of Landsbankinn at a level which is not competitive in the marketplace, and interferes with the Board's commercial management responsibility.

Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. for the year ended 31 December 2011 have been prepared on a going concern basis in accordance with International Financial Reporting Standards as adopted by the EU.

In our opinion the Consolidated Financial Statements of Landsbankinn hf. give a true and fair view of the consolidated financial performance of the Group for the year 2011, its consolidated financial position as at 31 December 2011 and its consolidated cash flows for the year 2011.

Furthermore, in our opinion, the Consolidated Financial Statements of Landsbankinn hf. and Endorsement of its Board of Directors and CEO give a fair view of the development and performance of the Group's operations and its position and describe the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Consolidated Financial Statements of Landsbankinn hf. for the year 2011 and confirmed them by their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements of Landsbankinn hf. be approved at the Annual General Meeting of Landsbankinn hf.

Reykjavík, 16 March 2012.

Board of Directors

Gunnar Helgi Hálfdanarson

Chairman

Þórdís Ingadóttir

Sigríður Hrólfsdóttir

Andri Geir Arinbjarnarson

Ólafur Helgi Ólafsson

CEO

Steinþór Pálsson

Independent Auditor's Report

To the Board of Directors and Shareholders of Landsbankinn hf.

We have audited the accompanying consolidated financial statements of Landsbankinn hf., which comprise the consolidated statement of financial position as at December 31, 2011, the consolidated income statement, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

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, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, 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 consolidated 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 entity's internal control. An audit also includes evaluating the appropriateness of accounting principles 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 Landsbankinn hf. as at December 31, 2011, and 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.

Report on the Board of Directors report

Pursuant to the legal requirement under Article 106, Paragraph 1, Item 5 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavík, 16 March 2012.

KPMG ehf.

Helgi F. Arnarson

Sigríður Helga Sveinsdóttir

Consolidated Statement of Financial Position as at 31 December 2011

Notes		2011	2010
	Assets		
8	Cash and balances with Central Bank	8,823	47,777
7,9,38	Bonds and debt instruments	221,848	161,559
7, 9	Equities and equity instruments	46,037	29,429
7, 10	Derivative instruments	159	23
11	Loans and advances to financial institutions	100,133	91,882
12, 38	Loans and advances to customers	639,130	592,954
13	Investments in equity-accounted associates	11,678	3,340
14	Property and equipment	6,437	5,016
15	Intangible assets	681	877
22	Deferred tax assets	3,003	1,522
16	Other assets	44,001	17,965
		1,081,930	**952,344**
17	Assets classified as held for sale	53,552	128,789
	Total assets	**1,135,482**	**1,081,133**
	Liabilities		
18	Due to financial institutions and Central Bank	112,876	147,478
19	Deposits from customers	443,590	371,558
10	Derivative instruments and short positions	7,916	7,119
22	Tax liabilities	70	1,979
20, 38	Secured bonds	277,076	261,313
7,21,38	Contingent bond	60,826	26,510
23	Other liabilities	23,499	18,701
		925,853	**834,658**
	Liabilities associated with assets classified as held for sale	9,385	61,609
	Total liabilities	**935,238**	**896,267**
24	**Equity**		
	Share capital	24,000	24,000
	Share premium	123,898	123,898
	Statutory reserve	3,781	2,932
	Retained earnings	47,952	31,828
	Total equity attributable to owners of the Bank	**199,631**	**182,658**
	Non-controlling interests	613	2,208
	Total equity	**200,244**	**184,866**
	Total liabilities and equity	**1,135,482**	**1,081,133**

The accompanying notes are an integral part of these consolidated financial statements.

All amounts are in ISK million

Consolidated Income Statement for the Year ended 31 December 2011

Notes		2011	2010*
	Interest income	60,831	61,060
	Interest expense	(28,182)	(36,374)
25	**Net interest income**	**32,649**	**24,686**
26	Net adjustments to loans and advances acquired at deep discount	58,489	49,702
4(h), 26	Loss from foreign currency linkage of loans and advances to customers	(40,726)	(18,157)
26, 60	Net impairment loss on loans and advances	(7,034)	(14,636)
7,21	Fair value change of contingent bond	(34,316)	(16,269)
	Net adjustments in valuation	**(23,587)**	**640**
	Net interest income after net adjustments in valuation	**9,062**	**25,326**
	Fee and commission income	7,437	6,292
	Fee and commission expense	(3,014)	(2,710)
27	**Net fee and commission income**	**4,423**	**3,582**
28, 30	Net gain on financial assets designated as at fair value through profit or loss	17,459	6,359
29, 30	Net gain on financial assets and liabilities held for trading	1,009	2,536
31	Net foreign exchange (loss) gain	(759)	14,623
32	Other income and (expenses)	(450)	(1,577)
	Other net operating income	**17,259**	**21,941**
	Total operating income	**30,744**	**50,849**
33	Salaries and related expenses	11,990	9,331
34	Other operating expenses	8,467	6,632
14	Depreciation and amortisation	771	1,311
23	Contribution to the Depositors' and Investors' Guarantee Fund	583	680
35	Acquisition-related costs	245	542
	Total operating expenses	**22,056**	**18,496**
13	Share of profit of equity-accounted associates, net of income tax	1,417	291
	Profit before tax	**10,105**	**32,644**
36	Income tax	1,411	(7,782)
	Tax on liabilities of financial institutions	(814)	(400)
	Profit for the year from continuing operations	**10,702**	**24,462**
	Profit for the year from discontinued operations, net of income tax	6,255	2,769
	Profit for the year	**16,957**	**27,231**
	Profit for the year attributable to:		
	Owners of the Bank		
	Profit for the year from continuing operations	10,702	24,462
	Profit for the year from discontinued operations	6,271	2,766
	Profit for the year attributable to owners of the Bank	**16,973**	**27,228**
	Non-controlling interests		
	(Loss) profit for the year from discontinued operations	(16)	3
	(Loss) profit for the year attributable to non-controlling interests	**(16)**	**3**
	Profit for the year	**16,957**	**27,231**

* Certain comparative amounts have been changed in conformity with current year presentation (see Note 2).

The accompanying notes are an integral part of these consolidated financial statements.

Landsbankinn hf. Consolidated Financial Statements 2011 All amounts are in ISK million

Consolidated Statement of Changes in Equity for the Year ended 31 December 2011

Notes

Notes	Change in equity for the year 2011	Share capital	Share premium	Statutory reserve	Retained earnings	Total	Non-controlling interests	Total
		Attributable to owners of the Bank						
	Balance at 1 January 2011	24,000	123,898	2,932	31,828	182,658	2,208	184,866
	Profit for the year				16,973	16,973	(16)	16,957
	Transfer to statutory reserve			849	(849)	0		0
	Increase in non-controlling interest due to acquisition of subsidiary					0	130	130
	Decrease in non-controlling interests due to sale of subsidiaries					0	(1,709)	(1,709)
24	**Balance at 31 December 2011**	**24,000**	**123,898**	**3,781**	**47,952**	**199,631**	**613**	**200,244**
	Change in equity for the year 2010							
	Balance at 1 January 2010	24,000	123,898	741	6,791	155,430	2,162	157,592
	Profit for the year				27,228	27,228	3	27,231
	Transfer to statutory reserve			2,191	(2,191)	0		0
	Increase in non-controlling interest due to acquisition of subsidiary					0	43	43
24	**Balance at 31 December 2010**	**24,000**	**123,898**	**2,932**	**31,828**	**182,658**	**2,208**	**184,866**

The accompanying notes are an integral part of these consolidated financial statements.

All amounts are in ISK million

Consolidated Statement of Cash Flows for the Year ended 31 December 2011

Notes		2011	2010
	Operating activities		
	Profit for the year	16,957	27,231
	Adjustments for non-cash items included in profit for the year	(32,349)	(39,310)
	Changes in operating assets and liabilities	(50,887)	(11,319)
	Interest received	58,630	98,601
	Interest paid	(24,650)	(43,398)
30	Dividends received	598	583
	Income tax paid	(1,254)	(470)
	Net cash (used in) from operating activities	**(32,955)**	**31,918**
	Investing activities		
5	Cash and cash equivalents included in net assets acquired	1,969	-
	Acquisition of additional shares in equity-accounted associates	(6,773)	-
14	Purchase of property and equipment	(377)	(91)
14	Proceeds from sale of property and equipment	12	79
15	Purchase of intangible assets	(76)	(104)
	Net cash used in investing activities	**(5,245)**	**(116)**
	Net change in cash and cash equivalents	(38,200)	31,802
	Cash and cash equivalents at the beginning of the year	52,654	21,166
	Effect of exchange rate changes on cash and cash equivalents held	(829)	(314)
	Cash and cash equivalents at 31 December	**13,625**	**52,654**
	Investing and financing activities not affecting cash flows		
5	Assets acquired and liabilities assumed from SpKef Savings Bank	(30,480)	-
5	Non-controlling interests	(116)	-
5	Provisional amount of the bond to be issued by the Icelandic State Treasury	30,596	-
5	Assets acquired and liabilities assumed from Avant hf.	9,722	-
5	Fair value of the Bank’s outstanding claim on Avant hf.	(9,722)	-

The accompanying notes are an integral part of these consolidated financial statements.

All amounts are in ISK million

Consolidated Statement of Cash Flows for the Year ended 31 December 2011

Notes		2011	2010
	Adjustments for non-cash items included in profit for the year		
25	Net interest income	(32,649)	(24,686)
26	Net adjustments to loans and advances acquired at deep discount	(58,489)	(49,702)
4(h), 26	Loss from foreign currency linkage of loans and advances to customers	40,726	18,157
26, 60	Net impairment loss on loans and advances	7,034	14,636
7,21	Fair value change of contingent bond	34,316	16,269
28	Net (gain) on financial assets designated as at fair value through profit or loss	(17,459)	(6,359)
29	Net (gain) on financial assets held for trading	(1,009)	(2,536)
31	Net foreign exchange loss (gain)	1,588	(14,309)
32	Loss on sale of property and equipment	61	18
32	(Loss) on repossessed collateral	1,030	-
14	Depreciation and amortisation	771	1,311
13	Share of profit of equity-accounted associates, net of income tax	(1,417)	(291)
36	Income tax	(1,411)	7,782
36	Tax on liabilities of financial institutions	814	400
	Profit for the year from discontinued operations, net of income tax	(6,255)	-
		(32,349)	**(39,310)**
	Changes in operating assets and liabilities		
	Change in reserve requirement with Central Bank	(452)	3,400
	Change in bonds and equities	(44,088)	(5,455)
	Change in loans and advances to financial institutions	(12,633)	(4,514)
	Change in loans and advances to customers	18,812	23,117
	Change in investments in associates	21,839	-
	Change in other assets	2,739	182
	Change in assets classified as held for sale	(16,831)	(9,612)
	Change in due to financial institutions and Central Bank	(55,082)	51,560
	Change in deposits from customers	18,095	(80,955)
	Change in tax liability	3,637	(3,667)
	Change in repossessed collateral	1,144	2,152
	Change in other liabilities	(1,275)	3,068
	Change in liabilities associated with assets classified as held for sale	13,208	9,405
		(50,887)	**(11,319)**
	Cash and cash equivalents is specified as follow:		
8	Cash and unrestricted balances with Central Bank	6,404	45,810
11	Bank accounts with financial institutions	7,221	6,844
	Cash and cash equivalents at 31 December	**13,625**	**52,654**

The accompanying notes are an integral part of these consolidated financial statements.

All amounts are in ISK million

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. Reporting entity

Landsbankinn hf. (formerly NBI hf., hereinafter referred to as the "Bank") was founded on 7 October 2008 by the Ministry of Finance on behalf of the Icelandic State Treasury. The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank operates based on Act No. 161/2002, on Financial Undertakings. The Bank has a license to operate based on Act No. 125/2008, on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances and it is supervised by the Financial Supervisory Authority in Iceland (FME). The registered address of the Bank's office is Austurstræti 11, 155 Reykjavík. The consolidated financial statements of the Bank for the year ended 31 December 2011 include the Bank and its subsidiaries (together referred to as the "Group" and individually as "Group entities"). The Group's primary lines of business are corporate and retail banking, investment banking, asset management and leasing services. The Group operates solely in Iceland.

The issue of these consolidated financial statements was authorised by the Board of Directors of the Bank on 16 March 2012.

2. Basis of preparation

Statement of compliance

The Consolidated Financial Statements for the year ended 31 December 2011 have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union.

Going concern

The Bank's management has assessed the Group's ability to continue as a going concern and it has a reasonable expectation that the Group has adequate resources to continue its operations. Accordingly, these consolidated financial statements have been prepared on a going concern basis.

Basis of measurement

The consolidated financial statements have been prepared on a historical cost basis except for:
- Financial assets and liabilities classified as at fair value through profit or loss, which are measured at fair value;
- Non-current assets and disposal groups classified as held for sale, which are measured at the lower of carrying amount or fair value less costs to sell.

Functional and presentation currency

Items included in the financial statements of each individual Group entity are measured using the currency of the economic environment in which the respective entity operates (its functional currency). All amounts are presented in Icelandic krona (ISK), which is also the Bank's functional currency, rounded to the nearest million unless otherwise stated.

Use of estimates and judgements

The preparation of financial statements requires the management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

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

Note 4 discusses estimates and assumptions which involve a substantial risk which could result in material adjustments to the carrying amounts of assets and liabilities during the next financial year.

Changes in presentation and classification

The Group changed during the year 2011 the presentation of the expense for the contribution to the Depositors' and Investors' Guarantee Fund. The contribution expense is presented in a separate line in the income statement but it was previously included in the line "Other operating expenses". The comparison amounts for the year 2010 in the income statement have been adjusted retrospectively in accordance with the new presentation as follows:
- New line "Contribution to the Depositors' and Investors' Guarantee Fund" in the amount of ISK 680 million;
- "Other operating expenses" decreased by ISK 680 million.

Other accounting developments

The new standards and amendments to standards which became effective for the Group starting from 1 January 2011 had no effect on the consolidated financial statements of the Group, except for the amendment to IFRS 7 Financial Instruments: Disclosures resulting from the Improvements to IFRSs (May 2010).

The Group early adopted the whole revised standard IAS 24 *Related Party Disclosures* (revised 2009) in its consolidated financial statements for the year ended 31 December 2010.

3. Significant accounting policies

The consolidated financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances. The accounting policies applied have been applied consistently to all periods presented. As explained in Note 2 certain changes were made in the year 2011 to the presentation of certain items in the income statement. There were no items of revenue or expense that the Group had to recognise in other comprehensive income during the years 2011 and 2010.

The principal accounting policies used in preparing these consolidated financial statements are set out below.

Correction of prior period error

In the year 2011 it was discovered that one of the assumptions (i.e. inflation) used by the Group to estimate the future cash flows from loans and advances to customers for the purpose of disclosing them in the maturity analysis was incorrect. The use of the incorrect assumption relates only to the amounts disclosed in the maturity analysis presented in the consolidated financial statements of the Group for previous periods. The use of the incorrect assumption had no effect on the amounts reported by the Group in the income statement or statement of financial position. The Group uses the correct assumption for the amounts disclosed in the maturity analysis as at 31 December 2011 and it has also corrected the comparative amounts disclosed for loans and advances to customers in the maturity analysis as at 31 December 2010. The correction of this prior period error has resulted in a decrease in the net liquidity position disclosed as at 31 December 2010 in Notes 68 and 69 from ISK 553,662 million to ISK 293,344 million when compared with the net liquidity position disclosed in the consolidated financial statements as at and for the year ended 31 December 2010.

Consolidation

(a) Subsidiaries

Subsidiaries are entities over which the Group has the power to govern financial and operating policies so as to obtain benefits from their activities, generally accompanied by a shareholding of over half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls an entity. Subsidiaries are fully consolidated from the date on which control is obtained, and are de-consolidated from the date on which control ceases.

The acquisition method is used to account for business combinations by the Group. The consideration transferred for the acquisition of a subsidiary is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition-related costs are expensed as incurred, except for costs related to the issue of debt and equity instruments. Identifiable assets acquired and liabilities assumed in a business combination are initially measured at their fair value on the acquisition date. A contingent liability of an acquiree is only recognised in a business combination if such a liability represents a present obligation and arises from a past event, and its fair value can be measured reliably. More information about how the Group accounts for goodwill acquired in a business combination is disclosed further in this note.

Inter-company transactions, balances, and unrealised gains on transactions between Group entities are eliminated in the consolidated financial statements. Unrealised losses are also eliminated unless the transaction provides evidence of impairment of the asset transferred. The accounting policies of subsidiaries have been changed where this was necessary to ensure consistency with the accounting policies adopted by the Group.

(b) Non-controlling interests

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 income statement and are included in equity in the consolidated statement of financial position, separately from equity attributable to owners of the Bank. The Group chooses on an acquisition-by-acquisition basis whether to measure non-controlling interests in an acquiree at fair value or according to the proportion of non-controlling interests in the acquiree's net assets. 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. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

Associates

Associates are those entities in which the Group has significant influence, but not control, over the financial and operating policies. Significant influence is presumed to exist when the Group holds, directly or indirectly, between 20 and 50 percent of the voting power of another entity. The Group accounts for investments in associates either using the equity method or as financial assets designated as at fair value through profit or loss, as described further in this note . Investments in associates which are accounted for by the Group using the equity method are presented in the consolidated statement of financial position in the line “Investments in equity-accounted associates”. Investments in associates which are accounted for by the Group as financial assets designated as at fair value through profit or loss are presented in the consolidated statement of financial position in the line “Equities and equity instruments”.

3. Significant accounting policies (continued)

Associates (continued)

Equity-accounted associates

Investments in equity-accounted associates are accounted for using the equity method from the date on which significant influence is obtained and are initially recognised at cost. Goodwill relating to an investment in an associate is included in the carrying amount of the investment. Amortisation of goodwill is not permitted. Any excess of the Group's share of net fair value of the associate's identifiable assets and liabilities over the cost of the investment is included as income in the determination of the Group's share of the associate's profit or loss in the period which the investment is acquired.

Because goodwill included in the carrying amount of an investment in an associate is not recognised separately, it is not separately tested for impairment according to the requirements for goodwill impairment testing in IAS 36 Impairment of Assets. Instead, the entire carrying amount of the investment is tested for impairment under IAS 36 by comparing its recoverable amount with its carrying amount, whenever application of the requirements in IAS 39 Financial Instruments: Recognition and Measurement indicates the investment may be impaired.

The Group's share of its equity-accounted associates' post-acquisition profits or losses is recognised in the income statement, and its share of movements in their reserves is recognised in the Group's equity reserves. Cumulative post-acquisition movements are adjusted against the carrying amount of the investment. When the Group's share of losses in an associate equals or exceeds its interest in the associate, including any other unsecured receivables, the Group does not recognise further losses, unless it has incurred obligations or made payments on behalf of the associate.

Unrealised gains on transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associates. Unrealised losses are also eliminated unless the transaction provides evidence of an impairment of the asset transferred. The accounting policies of associates have been changed where this was necessary to ensure consistency with the accounting policies adopted by the Group.

Associates designated as at fair value through profit or loss

The Group designates certain investments in associates which are held by the venture capital organisation of the Group upon initial recognition as at fair value through profit or loss and are accounted for in accordance with IAS 39 Financial Instruments: Recognition and Measurement. The Group measures such investments at fair value, with changes in fair value recognised in the consolidated income statement in the line "Net gain on financial assets designated as at fair value through profit or loss" in the period of the change.

Foreign currency translation

Transactions in foreign currencies are translated into the functional currency of the respective Group entity at the spot exchange rate at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are measured at amortised cost or fair value, as applicable, in their respective foreign currencies and are retranslated into the functional currency at the spot 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 period, adjusted for effective interest and payments during the period, and the amortised cost in foreign currency translated at the exchange rate at the end of the period. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are first measured at fair value in their respective foreign currencies and then retranslated into the functional currency at the spot exchange rate at the date that the fair value was determined. All foreign currency differences arising on retranslation are recognised in the income statement.

Financial assets and liabilities

(a) Recognition

The Group initially recognises loans and advances, deposits and debt securities issued on the date at which they are originated. All other financial assets and liabilities are initially recognised on the date at which the Group becomes a party to contractual provisions of the instrument. Regular way purchases and sales of financial assets are recognised on the date at which the Group committed itself to purchasing or selling the asset.

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

(b) Classification

The Group classifies all financial assets either as loans and receivables or as at fair value through profit or loss. The Group classifies all financial liabilities either as at fair value through profit or loss or at amortised cost.

A financial asset or liability is classified as held for trading if it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term or if it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking. Financial assets held for trading consist of debt, equity and derivative instruments. Financial liabilities held for trading consist of derivative liabilities and short positions, i.e. obligations to deliver financial assets borrowed by the Group and sold to third parties.

3. Significant accounting policies (continued)

Financial assets and liabilities (continued)

(b) Classification (continued)

The Group designates certain financial assets, including certain investments in associates, upon initial recognition as at fair value through profit or loss when the financial assets are part of portfolios of financial instruments which are managed and reported to senior management on a fair value basis in accordance with the Group's documented risk management or investment strategy.

Loans and advances are financial assets with fixed or determinable payments that are not quoted in an active market which the Group originates or acquires with no intention of trading them.

(c) Derecognition

The Group derecognises a financial asset when the contractual rights to cash flows from the asset expire, or when the Group transfers the rights to receive contractual cash flows relating to the financial asset in a transaction which substantially transfers all the risks and rewards of owning that asset. Any interest in transferred financial assets created or retained by the Group is recognised as a separate asset or liability.

The Group enters into transactions whereby it transfers assets recognised in its statement of financial position, but retains either all or substantially all of the risks and rewards of the transferred assets, or a portion of them. In cases where all or substantially all of the risks and rewards are retained, then transferred assets are not derecognised. Asset transfers whereby all or substantially all risks and rewards are retained include, for example, securities lending and repurchase transactions.

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or when they expire.

(d) Offsetting

Financial assets and liabilities are set off and the net amount presented in the statement of financial position when, and only when, the Group has a legal right to set off these amounts and intends either to settle on a net basis or to realise the asset and simultaneously settle the liability.

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

(e) Amortised cost measurement

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

(f) Fair value measurement

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

The Group measures the fair value of an instrument using quoted prices in an active market for that instrument, if available. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions on an arm's length basis. Where available, the relevant market's closing price determines the fair value of financial assets held for trading and of assets designated at fair value through profit or loss; this will generally be the last trading price.

If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. Valuation techniques include using recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses and option pricing models. The chosen valuation technique makes maximum use of market inputs, relies as little as possible on estimates specific to the Group, incorporates every factor that market participants would consider in setting a price, and is consistent with accepted economic methodologies for pricing financial instruments. Inputs to valuation techniques reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument. The Bank has a valuation committee which estimates fair value by applying models and incorporating observable market information and professional judgement. The Group calibrates valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument or based on other available, observable market data.

Should the transaction price differ from the fair value of other observable, current market transactions in the same instrument or be based on a valuation technique whose variables include only data from observable markets, the Group immediately recognises the difference between the transaction price and fair value (a Day 1 profit or loss). In cases where fair value is determined using data which is not observable, the difference between the transaction price and the model value is recognised in the income statement depending on the individual circumstances of the transaction but not later than when the inputs become observable, or when the instrument is derecognised.

3. Significant accounting policies (continued)

Financial assets and liabilities (continued)

(g) Impairment of financial assets

Impairment of loans and advances

At each reporting date, the Group assesses whether there is any objective evidence that a loan or loan portfolio is impaired. A loan or loan portfolio is considered impaired and impairment losses are incurred only when there is objective evidence of impairment as a result of one or more events occurring after initial recognition of the asset ("loss events") and these loss events impact future cash flows that can be estimated reliably for the loan or group of loans. Objective evidence of impairment includes observable data on the following loss events:

- significant financial difficulties of the borrower;
- a breach of contract, such as defaulting on installments or on interest or principal payments;
- the Group granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession that the lender would not otherwise consider;
- it becomes probable that the borrower will enter into bankruptcy or undergo other financial reorganisation; or
- observable data indicate a measurable decrease in 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 individual financial assets within the group, including adverse changes in the payment status of borrowers in the group or a general deterioration of economic conditions connected to that group of loans.

The Group defines loans that are individually significant and assesses first whether objective evidence of their impairment exists, and then makes individual or collective assessments for loans and advances that have not been defined as individually significant. If the Group determines that no objective evidence of impairment exists for a significant loan, it includes this loan in a group of loans with similar credit risk characteristics and collectively assesses them for impairment. Individual significant assets for which an impairment loss is recognised are not included in collective impairment assessments.

If there is objective evidence that an impairment loss has been incurred on loans or advances, the amount of the loss is measured as the difference between the asset's carrying amount and its recoverable value. The recoverable value is the present value of estimated future cash flows, excluding future credit losses that have not been incurred, discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced by the amount of impairment, using an allowance account, and the amount of the loss is recognised in the line item "Net impairment loss on loans and advances" in the income statement. In the case of loans with variable interest rates, the discount rate for measuring impairment losses is the current effective interest rate.

The present value calculated for estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure, less the costs involved in obtaining and selling the collateral, whether or not foreclosure is probable.

In order to conduct a collective evaluation of impairment, loans are grouped on the basis of similar credit risk characteristics on the basis of the Group's grading process, which considers asset type, collateral type, industry, past-due status and other relevant factors. These characteristics are appropriate for estimating future cash flows in groups of such loans by indicating the debtors' ability to pay every amount due according to contractual terms.

Groups of loans are collectively evaluated for impairment on the basis of expected cash flows and of peer review regarding assets with similar credit risk characteristics. Such peer review is also adjusted on the basis of current observable data, in order to reflect the effects of current conditions that did not affect the period on which peer review was originally based and to remove the effects of previous loss factors which no longer exist.

Estimates of changes in future cash flows in groups of assets are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of trends in the probability and magnitude of Group losses. The Group regularly reviews its methodology and assumptions for estimating future cash flows in order to minimise discrepancies between estimated losses and actual loss experience.

When a loan is uncollectible, it is written off against the provision for loan impairment in the statement of financial position. Loans are written off after all the necessary procedures have been completed, as set out in Group lending policies, and the amount of loss has been determined. Any subsequent recovery of an amount previously written off is recognised in the income statement in the line item "Net impairment loss on loans and advances".

If the amount of the impairment loss decreases in the subsequent period and the decrease can be related objectively to an event occurring after the original impairment was recognised, the previously recognised impairment loss is reversed by adjusting the allowance account. The amount of reversal is recognised in the income statement in the line item "Net impairment loss on loans and advances".

3. Significant accounting policies (continued)

Financial assets and liabilities (continued)

(g) Impairment of financial assets (continued)

Renegotiated loans

Where possible, the Group seeks to restructure loans rather than to take possession of collaterals. This may involve extending the payment arrangements and an agreement of new loan terms. Loans which are impaired and whose terms are renegotiated are not considered to be new loans. Once the terms have been renegotiated these loans are no longer considered past due and any subsequent impairment is measured using the original effective interest rate as calculated before the modification of terms. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. These loans continue to be subject to individual or collective impairment assessment. Loans which are not individually impaired and whose terms are renegotiated are accounted for as new loans. Accordingly, the original loans are derecognised and the renegotiated loans are recognised as new loans.

Cash and cash equivalents

For the purpose of the statement of cash flows, cash and cash equivalents are defined as cash, unrestricted balances with the Central Bank and unrestricted balances with financial institutions.

Bonds and equities

Bonds and equities which are classified as at fair value through profit or loss are recognised at fair value in the statement of financial position both initially and subsequently to initial recognition. Transaction costs are recognised directly in the income statement. Gains and losses arising from changes in fair value are recognised directly in the consolidated income statement in the line items "Net gain on financial assets and liabilities held for trading" and "Net gain on financial assets designated as at fair value through profit or loss", respectively. The gains and losses include interest income on bonds but exclude foreign exchange gains and losses, which are included in the line item "Net foreign exchange (loss) gain".

Bonds which are classified as loans and receivables are initially measured at fair value plus directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the bonds and it is recognised in the line item "Interest income" in the income statement.

Derivative instruments

Derivatives are initially recognised in the statement of financial position at fair value, with transaction costs being recognised in the income statement. Subsequently, derivatives are carried at fair value, with all fair value changes recognised in the line item "Net gain on financial assets and liabilities held for trading" in the income statement, except for fair value changes of derivative currency forwards and net foreign exchange differences arising from OTC currency options, which are included in the line item "Net foreign exchange (loss) gain" in the income statement. In the statement of financial position, derivatives with positive fair values are recognised as assets and derivatives with negative fair values are recognised as liabilities. The Group does not apply hedge accounting.

Loans and advances

Loans and advances are initially measured at fair value plus directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of loans and advances. Interest income on loans and advances is recognised in the line item "Interest income" in the income statement and foreign exchange differences in the line item "Net foreign exchange (loss) gain".

3. Significant accounting policies (continued)

Loans and advances (continued)

Loans and advances acquired at deep discount

The Bank acquired loans and advances from Landsbanki Íslands hf. at deep discount that reflected credit losses which were already incurred at acquisition date. The deep discount was included in the fair value of these loans and advances estimated at initial recognition. The deep discount is also included in the estimated future cash flows used by the Group to calculate the amortised cost and effective interest rate of these loans and advances.

At each reporting date, the Group assesses the current status of these loans and advances and whether there is any objective evidence of changes in expected cash flows, for example due to differences in estimated and actual payments, changes in the value of collaterals and improvement in the financial situation of debtors. If there is any change in expected cash flows, the Group recalculates the carrying amount of these loans and advances as the present value of the revised estimated future cash flows, using their effective interest rate. The difference between the revised carrying amount of the loans and their current carrying amount, which includes accrued interest, indexation, foreign exchange differences and actual payments received by the Group, is recognised on a portfolio basis in the income statement in the line “Net adjustments to loans and advances acquired at deep discount”.

The Group recognises interest and indexation on these loans and advances based on their carrying amount and only to the extent that the interest and indexation are deemed to be collectible. The interest and indexation are recognised in the income statement in the line ”Interest income”.

Property and equipment

All property and equipment is recognised at cost, less accumulated depreciation and accumulated impairment losses. The cost includes expenditures directly attributable to acquiring these assets.

Subsequent costs are included in an asset’s carrying amount only if it is probable that future economic benefits associated with the item will flow to the Group and if these costs can be reliably measured. All other repairs and maintenance are charged to the income statement of the financial period in which their costs are incurred.

Depreciation of any property and equipment is calculated using the straight-line method. This method is applied to the depreciable amount of the assets, which is their cost less their residual value over their estimated useful lives, as follows:

Buildings	25-50 years
Computer hardware	3 years
Other equipment and motor vehicles	3-10 years

The assets' residual values and useful lives are reviewed annually and adjusted where appropriate.

Gains and losses on disposals are determined by comparing the sale price of an asset with its carrying amount on the date of sale. Gains and losses are included in the item "Other income and expenses" in the income statement.

Intangible assets

(a) Computer software licenses

Acquired computer software licenses are capitalised on the basis of the costs incurred to acquire and bring them into service. Computer software licenses recognised as intangible assets are amortised over their useful life, which is estimated to be 3 - 5 years.

The costs associated with maintaining computer software are recorded as expenses at the time they are incurred.

3. Significant accounting policies (continued)

Intangible assets (continued)

(b) Goodwill

Goodwill is recognised as an asset only if acquired in a business combination. It is recognised as of the acquisition date and measured as the aggregate of (a) the fair value of the consideration transferred, (b) the recognised amount of any non-controlling interest in the acquiree, and (c) the fair value of any previously held equity interest in the acquiree, less the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed, all measured as at the acquisition date. The consideration transferred includes the fair value of assets transferred, liabilities incurred and equity interests issued by the Group. In addition, consideration transferred includes the fair value of any contingent consideration.

Following initial recognition, goodwill is measured at cost, less any accumulated impairment losses. Goodwill is generally reviewed for impairment annually, but more frequently if events or changes in circumstances indicate a potential impairment of the carrying amount. For the purpose of impairment testing, goodwill is allocated as of the acquisition date to each of the Group's cash-generating units (CGUs) or group of CGUs which are expected to benefit from the synergies of the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units. Each unit to which this goodwill is allocated represents the lowest level within the Group at which the goodwill is monitored for internal management purposes. Where goodwill is attached to a particular unit of a CGU (or of a group of CGUs) and part of the operations within that unit is disposed of, the goodwill that is associated with the operations disposed of is included in the carrying amount of these operations when determining the gain or loss incurred upon disposing of the operations.

Impairment of non-financial assets

Assets with an indefinite useful life are not subject to amortisation but are tested annually for impairment. Assets that are subject to amortisation are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is either an asset's fair value less selling costs or its value in use, whichever is higher. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash flows (cash-generating units). With the exception of goodwill, non-financial assets are reviewed at each reporting date for any possible reversal of impairment.

Deferred income tax

Deferred tax assets are recognised when it is probable that future taxable profit will be available against which deductible temporary differences can be utilised.

Deferred income tax is recognised in full as a liability, based on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred income tax is not recognised if it arises from the initial recognition of an asset or liability in a transaction other than a business combination, which at the time of the transaction affects neither the Group's accounting nor its taxable profit or loss. Deferred income tax is determined using tax rates (and laws) that have been enacted or substantially enacted by the reporting date and are expected to apply when the related deferred income tax asset is realised or the deferred income tax liability is settled.

The principal temporary differences arise from fair value changes in various financial assets and liabilities and the difference between the fair values of acquired assets and their tax base.

3. Significant accounting policies (continued)

Assets and liabilities classified as held for sale

The Group classifies non-current assets (or groups of assets together with related liabilities) as held for sale when their carrying amount will be recovered principally through a sale transaction. This is usually the case with collateral foreclosed by the Group which it holds as security for loans and advances, including assets and liabilities of subsidiaries over which the Group obtains control through foreclosure of collateral and/or financial restructuring.

A non-current asset (or group of assets together with related liabilities) is considered to be recovered principally through a sale transaction when the asset's sale is highly probable and it is available for immediate sale in its present condition, subject to ordinary and customary terms on the sale of such assets. Management must be committed to the sale and must actively market the asset for sale at a price that is reasonable in relation to its current fair value. A further condition is that the sale is expected to qualify for recognition as completed within one year from the date of classification.

Assets and disposal groups classified as held for sale are measured at the lower of their carrying amount and their fair value less costs to sell. Additional net assets that become part of a disposal group, for example due to profits generated by the disposal group, increase the carrying amount of the disposal group but not in excess of the fair value less costs to sell of the disposal group as determined at each reporting date.

In the case of single assets classified by the Group as held for sale the Group determines their fair value less costs to sell by reference to the current market price at each reporting date. In the case of subsidiaries classified as held for sale, the Group determines the fair value of disposal groups based on discounted cash flows methodologies. Costs to sell are deemed to be only the costs which are incremental and directly attributable to the disposal of the disposal groups, excluding finance costs and income tax expense.

Deposits and secured bonds

The Group's sources of debt funding consist of deposits, loans from financial institutions and debt securities.

When the Group sells a financial asset and simultaneously enters into an agreement to repurchase the asset or a similar asset at a fixed price on a future date ("repo"), this arrangement is accounted for as an amount due to financial institutions or the Central Bank, and the underlying asset continues to be recognised in the Group's financial statements.

The Group classifies financial instruments as financial liabilities or equity instruments in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset or an equity instrument.

Deposits and borrowings are initially measured at fair value plus any directly attributable transaction costs. Subsequently, they are measured at their amortised cost using the effective interest method. The fair value of a financial liability with a demand feature such as a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

Contingent bond

The contingent bond is a contingent obligation of the Bank to issue a bond to Landsbanki Íslands hf. on 31 March 2013 as an additional consideration for the assets and liabilities transferred from Landsbanki Íslands hf. on 9 October 2008. The issue of the bond and its nominal amount are contingent on the excess of the value of certain pools of assets, to be determined as at 31 December 2012, over the future value of the acquisition price of those assets as at 9 October 2008, subject to specified adjustments.

The contingent obligation of the Bank is classified as a financial liability and measured initially at fair value. Subsequently, it is measured at fair value, with any resulting gain or loss recognised in the line item "Fair value change of contingent bond" in the income statement.

Short positions

Short positions are obligations of the Group to deliver financial assets borrowed by the Group and sold to third parties. These obligations are initially recognised in the statement of financial position at fair value, with transaction costs being recognised in the income statement. Subsequently, they are carried at fair value, with all fair value changes recognised in the income statement in the line item "Net gain on financial assets and liabilities held for trading".

3. Significant accounting policies (continued)

Financial guarantee contracts

Financial guarantee contracts are contracts requiring the issuer to make specified payments to reimburse the holder for a loss it will incur if a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Such financial guarantees are issued by the Group to banks, financial institutions or other parties on behalf of Group customers so that they can secure loans, overdrafts and other banking facilities.

Financial guarantees issued by the Group are initially recognised in the financial statements at fair value on the date the guarantee was given. Subsequent to initial recognition, the Group's liability under such a guarantee is determined as the initial measurement, less amortisation of fee income earned on a straight line basis over the life of the guarantee, or the best estimate for settling any financial obligation that has arisen through the guarantee by the reporting date, whichever is higher. These estimates are determined on the basis of experience with similar transactions and the history of past losses, supplemented by management judgement.

Contingent liabilities and provisions

The Group does not recognise contingent liabilities as liabilities in the statement of financial position, other than contingent liabilities which are assumed in a business combination and which have a fair value that can be measured reliably. A contingent consideration transferred by the Group in a business combination is recognised at its acquisition-date fair value. The Group classifies the obligation to pay contingent consideration as liability or equity and accounts for changes in fair value in accordance with applicable IFRSs.

Provisions for expenditures such as those related to legal claims or restructuring are recognised as incurred when (i) the Group has as a result of past events a present legal or constructive obligation to pay, (ii) it is more likely than not that an outflow of resources will be required to settle the obligation, and (iii) the amount has been reliably estimated.

Provisions are measured at the present value of the expenditures expected for settling the obligation. A pre-tax rate is used which reflects current market assessments of the time value of money and the risks specific to the obligation. Any increase in the provision due to the passage of time is recognised as interest expense.

Employee benefits

All Group entities have defined contribution plans, with the entities paying a fixed contribution to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognised as an expense when they become due. The Group has no defined benefit pension plan.

Share capital

(a) Share issue costs

Costs directly attributable to the issue of new shares are presented separately in equity as a deduction from share premium, net of any related income tax benefits.

(b) Dividends on ordinary shares

Dividends on ordinary shares are recognised in equity during the period in which they are approved by the Bank's shareholders' meeting.

Fiduciary activities

The Group acts as a custodian, holding or placing assets on behalf of individuals, institutions and pension funds, including various mutual funds managed by the Group. These assets, together with the income arising from them, are excluded from these financial statements, since they are not assets of the Group.

Interest income and expense

The interest income and expense presented in the consolidated income statement consist of interest income and expense from financial assets and liabilities measured at amortised cost.

The interest income and expense is recognised in the consolidated income statement using the effective interest method. The effective interest rate is the rate that 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. When calculating the effective interest rate, the Group estimates future cash flows considering all contractual terms of the financial instrument but it does not consider any future credit losses. The calculation of the effective interest rate includes all fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or liability.

3. Significant accounting policies (continued)

Net impairment loss on loans and advances

Impairment charges relating to loans and advances to financial institutions and customers are presented in the consolidated income statement under the item "Net impairment loss on loans and advances". Once impairment has been recognised, subsequent interest income is recognised at the rate of interest used for discounting future cash flows when measuring impairment losses.

Fee and commission income and expense

Fees and commissions are generally recognised on an accrual basis as the related services are performed. Arrangement fees are generally deferred together with related direct costs and recognised as an adjustment to the effective interest rate of a loan. Commissions and fees for participation in negotiating a transaction for a third party – such as arrangement of transactions with equities or other securities or the purchase or sale of businesses – are recognised upon completion of the underlying transaction. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportioned basis. Asset management fees related to investment funds are recognised rateably over the period when the service is provided. The same principle for reporting income is applied to other custody services that are continuously provided over an extended period of time.

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

The net gain on financial assets designated as at fair value through profit or loss relates to financial assets designated by the Group as at fair value through profit or loss and includes:
• All realised and unrealised changes in fair value;
• Interest income on an accrual basis; and
• Dividend income, which is recognised when the Group's right to receive payment is established.

Net gain on financial assets and liabilities held for trading

The net gain on financial assets and liabilities held for trading relates to financial assets and liabilities classified by the Group as held for trading and includes:
• All realised and unrealised changes in fair value;
• Interest income on an accrual basis;
• Dividend income, which is recognised when the Group's right to receive payment is established; and
• Foreign exchange gains and losses arising from derivative financial assets and liabilities, except for changes in fair value of derivative currency forwards and net foreign exchange differences arising from OTC currency options, which are included in the line item "Net foreign exchange (loss) gain" in the income statement.

Net foreign exchange (loss) gain

Net foreign exchange gain (loss) includes all gains and losses arising from settlement of transactions in foreign currencies and translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies, including non-derivative financial assets and liabilities classified as held for trading and financial assets designated as at fair value through profit or loss. Foreign exchange gains and losses arising from derivative financial assets and liabilities are included in the line item "Net gain on financial assets and liabilities held for trading", except for fair value changes of derivative currency forwards and net foreign exchange differences arising from OTC currency options, which are included in the line item "Net foreign exchange (loss) gain" in the income statement.

Other income and expenses

Other income and expenses include revenue arising from recharging agreements and gains and losses on repossessed collateral and property and equipment.

Leases

(a) When a Group entity is the lessee

The leases into which the Group enters as a lessee are primarily operating leases. Over the period of the lease, payments for operating leases are charged to the income statement on a straight-line basis, in the line item "Other operating expenses".

If an operating lease is terminated before the lease period has expired, any payment to the lessor required by way of penalty is recognised as an expense in the period in which termination occurs.

(b) When a Group entity is the lessor

When assets are held subject to a finance lease, the present value of lease payments is recognised as a receivable, under loans and advances to customers. Finance income from such a lease is recognised over the term of the lease, using a method that reflects a constant periodic rate of return on the Group's net investment in the lease.

3. Significant accounting policies (continued)

Discontinued operations

The Group presents discontinued operations in a separate line of the consolidated income statement if an entity or a component of an entity has been disposed of or is classified as held for sale and:
• Represents a major separate line of business;
• Is a part of a single co-ordinated plan to dispose of a major separate line of business; or
• Is a subsidiary acquired exclusively with a view to resale.

The profit from discontinued operations disclosed in the consolidated income statement consists of (a) post-tax profit or loss from discontinued operations and (b) post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets or the disposal groups constituting the discontinued operation. A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting, from the rest of the Group's operations and cash flows.

New standards, amendments to standards and interpretations not yet adopted

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2011, and have not been applied in preparing these consolidated financial statements. The new standards and amendments to standards which could have a material effect on the consolidated financial statements of the Group are the following:

The amendments to IFRS 7 *Financial Instruments: Disclosures – Transfers of Financial Assets*, according to which an entity is required to disclose certain information about (a) the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and (b) the nature of, and risks associated with, an entity's continuing involvement in derecognised financial assets. These amendments will become mandatory for the Group starting with its consolidated financial statements for the year 2012. Disclosures required by these amendments will not be required for any periods that begin before 1 January 2012. The amendments will impact only the extent of the disclosures that the Group will be required to provide in its consolidated financial statements in respect of transfers of financial assets.

The amendments to IAS 32 and IFRS 7 – *Offsetting Financial Assets and Financial Liabilities*, which clarify when an entity currently has a legally enforceable right to set-off financial assets and financial liabilities and require an entity to disclose certain information about the effect or potential effect on an entity's financial position resulting from netting arrangements. If endorsed by the EU, the amendments to IAS 32 will become mandatory for the Group starting with its consolidated financial statements for the year 2014 and the amendments to IFRS 7 starting with its consolidated annual and interim financial statements for the year 2013. Retrospective application is required for both amendments to IAS 32 and IFRS 7. The Group does not plan to early adopt these amendments and it is currently in the process of evaluating their impact on its consolidated financial statements. However, the Group already expects that it will be required to provide more extensive disclosures about the effect or potential effect of netting arrangements on the Group's financial position.

IFRS 10 *Consolidated Financial Statements*, which establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 establishes control as the basis for determining which entities are consolidated. The principle of control sets out three elements of control: (a) power over an investee, (b) exposure, or rights, to variable returns from involvement with the investee, and (c) the ability to use power over the investee to affect the amount of the investor's returns. IFRS 10 contains guidance on how to apply the control principle in various circumstances, including situations where the investor holds less than a majority of voting rights. IFRS 10 carries forward the consolidation procedures from IAS 27 Consolidated and Separate Financial Statements (as amended in 2008). IFRS 10 supersedes IAS 27 (2008) and SIC-12 Consolidation – Special Purpose Entities. If endorsed by the EU, IFRS 10 will become mandatory for the Group starting with its consolidated financial statements for the year 2013, with retrospective application required with certain exceptions. The Group does not plan to early adopt IFRS 10 and it is currently in the process of evaluating the possible impact of IFRS 10 on its consolidated financial statements.

IFRS 12 *Disclosure of Interests in Other Entities*, which includes all the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. In general, the disclosures required by IFRS 12 are more extensive than the disclosures required by currently effective standards. If endorsed by the EU, IFRS 12 will become mandatory for the Group starting with its consolidated financial statements for the year 2013, with retrospective application required. The Group does not plan to early adopt IFRS 12 and it is currently in the process of evaluating the impact of IFRS 12 on its consolidated financial statements. However, the Group already expects that it will be required to provide more extensive disclosures about the nature of, and risks associated with, the Bank's interests in other entities and the effects of those interests on the Group's financial position, financial performance and cash flows.

3. Significant accounting policies (continued)

New standards, amendments to standards and interpretations not yet adopted (continued)

IFRS 13 *Fair value measurement* , which establishes a single framework for measuring fair value of both financial and non-financial items and sets out related disclosure requirements. IFRS 13 does not give rise to any new requirements as to when fair value measurements are required. Instead, IFRS 13 provides guidance on how fair value should be measured and disclosed when required or permitted under other IFRSs. In general, the disclosures required by IFRS 13 are more extensive than the disclosures required by currently effective standards. If endorsed by the EU, IFRS 13 will become mandatory for the Group starting with its consolidated financial statements for the year 2013. The Group will have to apply the measurement requirements of IFRS 13 prospectively as of the beginning of the annual period in which it will apply IFRS 13 initially but it will have a choice as to whether it provides the disclosures required by IFRS 13 for comparative periods before the period of initial application. The Group does not plan to early adopt IFRS 13 and it is currently in the process of evaluating the possible impact of IFRS 13 on its consolidated financial statements. However, the Group already expects that it will be required to provide more extensive disclosures about fair value measurements.

IFRS 9 *Financial instruments* , which replaces those parts of IAS 39 *Financial Instruments: Recognition and Measurement relating* to the classification and measurement of financial assets and financial liabilities. The key features of IFRS 9 are the following:
• Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.
• An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest. All other debt instruments are to be measured at fair value through profit or loss.
• All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There will be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.
• Derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not to be separated; instead the hybrid financial instrument is to be assessed in its entirety as to whether it should be measured at amortised cost or fair value.
• IFRS 9 (2010) generally requires that the amount of change in fair value attributable to changes in the credit risk of liabilities designated by an entity as at fair value through profit or loss be presented in other comprehensive income, with only the remaining amount of the total gain or loss included in profit or loss. The amounts presented in other comprehensive income may not be subsequently reclassified to profit or loss but may be transferred within equity. However, if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, then the whole fair value change must be presented in profit or loss. Additionally, all fair value gains and losses continue to be included in profit or loss for loan commitments and financial guarantee contracts designated as fair value through profit or loss.

Currently, IASB has issued two versions of IFRS 9. The first version was issued in 2009 and the second version was issued in 2010. The 2010 version includes all the requirements of the 2009 version without amendment, but in addition, it also includes the requirements with respect to the classification and measurement of financial liabilities and the derecognition of financial assets and financial liabilities. The 2010 version supersedes the 2009 version. However, for annual periods beginning before 1 January 2015, an entity may elect to apply the 2009 version rather than the 2010 version.

If endorsed by the EU, IFRS 9 will become mandatory for the Group starting with its consolidated financial statements for the year 2015. Upon initial application of IFRS 9 the Group will have a choice as to whether it will restate prior periods or not and it will need to provide certain disclosures about the transition from IAS 39 to IFRS 9. The Group does not plan to early adopt IFRS 9 and it is currently in the process of evaluating the potential effect of this standard. Given the nature of the Group's operations, the standard is expected to have a pervasive impact on the consolidated financial statements of the Group.

4. Critical accounting estimates and judgements in applying accounting policies

(a) Effective interest rate on loans and advances

The Bank acquired loans and advances from Landsbanki Íslands hf. at a deep discount, reflecting incurred credit losses. The effective interest rate is computed for these loans by estimating their future cash flows and comparing it with their acquisition prices. Estimating the cash flows involves management judgements about the debtors' financial situation and ability to pay their debts, the net realisable value of any underlying collateral and the timing of any potential cash flows. These estimates have a significant risk of resulting in material adjustments to the carrying amounts of loans within the next financial year.

(b) Impairment losses on loans and advances

To assess impairment, the Group reviews its loan portfolios on at least a quarterly basis. To determine whether an impairment loss should be recognised, the Group judges whether there is any observable data indicating a measurable decrease in estimated future cash flows from a portfolio of loans, before any decrease in individual loans becomes identifiable within that portfolio. The evidence may include either observable data indicating that an adverse change has occurred in the payment status of the borrowers in a group, or national or local economic conditions correlating with defaults on assets in the group. In order to schedule its future cash flows, management uses estimates based on historical loss experience, together with objective evidence of impairment in homogenous portfolios. The methodology and assumptions for estimating both the amount and timing of future cash flows are reviewed regularly in order to reduce potential discrepancies between loss estimates and actual loss experience.

(c) Valuation of financial instruments

The fair value of financial instruments where no active market exists or where quoted prices are not otherwise available are determined by using valuation techniques. In these cases, the fair values are estimated from observable data in respect of similar financial instruments or using models. Where market observable inputs are not available, they are estimated based on appropriate assumptions. Where valuation techniques (for example, models) are used to determine fair value, they are validated and periodically reviewed by qualified and independent personnel. All models are certified before use, and calibrated to ensure that the outputs reflect actual data and comparative market prices. Wherever practical, models are confined to observable data; however, areas such as volatility, correlation and credit risk, whether own or counterparty, require management to make estimates. Changing assumptions on these factors could affect the reported fair value of financial instruments.

(d) Financial asset and liability classification

The Group's accounting policies provide scope for assets and liabilities to be classified at initial recognition into different categories in certain circumstances:

• Where financial assets or liabilities have been classified as "held for trading", the Group has determined that they meet the description of such assets and liabilities set out in its accounting policies.

• Where financial assets have been designated as at fair value through profit or loss, the Group has determined that they meet the criteria set out in the accounting policies.

• Where financial assets have been classified as loans and receivables, the Group has determined that they meet the criteria set out in the accounting policies.

4. Critical accounting estimates and judgements in applying accounting policies (continued)

(e) Assets classified as held for sale

The Group classifies assets and groups of assets together with related liabilities as held for sale if such assets or disposal groups are immediately available for sale in their present condition, subject to terms that are usual and customary for selling such assets or disposal groups, if management is committed to selling such assets and is actively looking for a buyer, if the assets are being actively marketed at a reasonable sales price in relation to their fair value, if completion of the sale is expected within one year and if sale is considered highly probable. However, events and circumstances may extend the period to complete the sale beyond one year. An extension of the period required to complete the 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 Group's control and the Group remains committed to its plan to sell the asset (or disposal group).

When classifying assets as held for sale the Group has determined that the classification criteria have been met.

(f) Deferred tax assets

Deferred tax assets are recognised in the consolidated statement of financial position. In respect of tax losses carried forward, they are recognised to the extent that it is probable that taxable profits will be available against which to utilise the losses. Judgement is required to determine the amount of deferred tax assets that may be recognised, based upon the likely timing and level of future taxable profits, as well as tax-planning strategies.

(g) Liquidity

The key measure used by the Group for monitoring liquidity risk is the ratio of core liquid assets to deposits. The calculation of this ratio requires judgement as to which assets to consider liquid. Furthermore, the maturity of some assets included in the maturity analysis of the financial assets and liabilities disclosed in the notes, such as loans acquired from Landsbanki Íslands hf., is based on expected future cash flows rather than contractual maturities. The estimation of the amount and timing of the cash flows from these financial assets involves management judgements about the debtors' financial situations and their abilities to repay their debts, the net realisable value of any underlying collateral and the timing of any possible cash flows.

(h) Denomination currencies and interest rates of lease and loan agreements

The District Court of Reykjavík rendered in its ruling from 23 February 2011, established in the case of Landsbankinn hf. versus bankrupt estate of Motormax ehf., that certain foreign currency loan agreements to companies are in fact loan agreements in Icelandic krona which fall under the scope of Act. No. 38/2001, on interest and indexation. The indexation of such ISK denominated loans to the exchange rate of foreign currencies constitutes indexation which is not authorised by the Act. Furthermore, the District Court ruled that these loan agreements should bear from inception the lowest interest rates on unindexed ISK denominated loans as published by the Central Bank of Iceland. On 9 June 2011 the Supreme Court of Iceland ruled in this case and confirmed the District Court's verdict.. An additional loss of ISK 2,684 million was recognized in the fourth quarter of 2011 in the consolidated income statement in the line "Loss from foreign currency linkage of loans and advances to customers" as a result of recalculations of loans subject to this ruling.

In 2010 and 2011 the Supreme Court of Iceland delivered rulings on the illegality of provisions of currency-indexation in loan agreements. Under law, such loans are to bear the lowest interest rates of un-indexed loans denominated in Icelandic krona as calculated by the Central Bank. On 15 February 2012 the Court ruled that a lender could not apply the Central Bank interest rates under circumstances specified in the ruling, inter alia, as the lender had issued final receipt of payment of interests. The case did not involve any Group entity but may be of relevance for the Bank. The precedent set by this new ruling is not clear when these consolidated financial statements are authorised for issue. However, the Group has accounted for the potential impact of this new ruling on the consolidated financial statements of the Group for the year 2011, based on the management's current best estimate, and recognised expenses in the amount of ISK 38,042 million in the line “Loss from foreign currency linkage of loans and advances to customers" in the consolidated income statement for the year ended 31 December 2011. More Court rulings are needed to get a clarification of the precedence and therefore the total amount of the estimated impact might change accordingly.

5. Business combinations

Acquisition of Avant hf.

As one of the major creditors of Avant hf., a company whose principal business operation was vehicle leasing and lending services to individuals and corporations, the Bank obtained control of Avant hf. on 24 January 2011. The control obtained was based on the composition agreement of Avant hf., which was confirmed by the District Court of Reykjavík on 24 January 2011. Under the composition agreement the Bank accepted 100% of the common shares in Avant hf. as payment for one of the Bank's claims on Avant hf. amounting to ISK 2.0 billion. On 6 October 2011, the Bank finalised its merger with Avant hf.

The fair values of the assets acquired and liabilities assumed recognised as of the acquisition date, 24 January 2011, were the following:

Identifiable assets acquired and liabilities assumed	Fair value
Assets	
Cash and balances with Central Bank	683
Loans and advances to customers	9,360
Deferred tax assets	1,270
Other assets	23
Assets classified as held for sale	311
Total	**11,647**
Liabilities	
Other liabilities	(1,925)
Total	**(1,925)**
Total identifiable net assets	**9,722**
Fair value of the Bank’s outstanding claim on Avant hf.	(9,722)
Goodwill	**0**

	At 24 January 2011			
Loans and advances to customers	Acquiree's carrying amounts*	Contractual cash flows**	Cash flows expected to be collected**	Fair value
Corporations and public entities	7,868	10,815	9,166	7,868
Individuals	1,492	2,045	1,738	1,492
Total	**9,360**	**12,860**	**10,904**	**9,360**

*Unaudited financial information representing the carrying amounts of assets and liabilities transferred from Avant hf. immediately before the acquisition date.

**The cash flows presented in the table above consist of undiscounted principal and interest receivable.

Apart from the claim which was settled by Avant hf. issuing 100% of its common shares to the Bank, Avant hf. owed ISK 12.4 billion to the Bank at acquisition date. The Bank’s outstanding claim and the corresponding liability of Avant hf. have been eliminated from the consolidated financial statements of the Bank.

Since the acquisition in January 2011 Avant hf. has contributed total operating income of ISK 102 million and profit of ISK 12 million to the Group's results.

Landsbankinn hf. Consolidated Financial Statements 2011 All amounts are in ISK million

5. Business combinations (continued)

Acquisition of SpKef Savings Bank

On 7 March 2011, the Bank took over all assets, liabilities and operations of SpKef Savings Bank in accordance with the decision of the Financial Supervisory Authority in Iceland (FME). SpKef Savings Bank was owned entirely and directly by the National Treasury previous to the transfer. The National Treasury has made a commitment to issue a bond payable to the Bank in order to compensate for the negative difference between the fair value of the assets taken over and liabilities assumed by the Bank. The takeover was negotiated on an arm's length basis under generally accepted commercial terms. The Bank and the National Treasury currently disagree on the fair value of financial assets of SpKef under the due diligence process which is still in progress. Consequently, the current assessment of the value of financial assets of SpKef in the consolidated statement of financial position has been determined by the Bank's current best estimate of fair value. The assets acquired from SpKef Savings Bank have been recognised by the Group at a preliminary fair value amount of ISK 45.3 billion. The liabilities assumed from SpKef have been recognised by the Group at a provisional amount of ISK 75.8 billion. The fair value and provisional amounts and their presentation are subject to adjustments in future reporting periods which may result from the completion of the due diligence and valuation process.

The Bank's current best estimate of the values of the assets acquired and liabilities assumed recognised as of the acquisition date, 7 March 2011, were the following:

Identifiable assets acquired and liabilities assumed	Acquiree's carrying amounts*	Value adjust-ments	The Bank's current valuation	Elimi-nations***	Effect on the Group
Assets					
Cash and balances with Central Bank	1,295	-	1,295	(10)	1,285
Bonds and debt instruments	9,969	94	10,063	-	10,063
Equities and equity instruments	747	(675)	72	-	72
Loans and advances to financial institutions	1,175	(40)	1,135	(1,612)	(477)
Loans and advances to customers	42,596	(14,001)	28,595	(384)	28,211
Investments in equity-accounted associates	234	-	234	-	234
Property and equipment	2,441	(828)	1,613	-	1,613
Deferred tax assets	205	-	205	-	205
Other assets	70	-	70	-	70
Assets classified as held for sale	2,095	(102)	1,993	-	1,993
Total	**60,827**	**(15,552)**	**45,275**	**(2,006)**	**43,269**
Liabilities					
Due to financial institutions and Central Bank	(13,885)	-	(13,885)	-	(13,885)
Deposits from customers	(57,575)	-	(57,575)	10	(57,565)
Tax liabilities	(74)	-	(74)	-	(74)
Other borrowings	(2,058)	-	(2,058)	1,996	(62)
Other liabilities	(264)	(1,899)	(2,163)	-	(2,163)
Total	**(73,856)**	**(1,899)**	**(75,755)**	**2,006**	**(73,749)**
Total identifiable net assets			**(30,480)**	**0**	**(30,480)**
Non-controlling interests			(116)	-	(116)
Provisional amount of the bond to be issued to the Bank by the National Treasury			**(30,596)**	**0**	**(30,596)**

	At 7 March 2011			
Loans and advances to customers	**Acquiree's carrying amounts***	**Contractual cash flows****	**Cash flows expected to be collected****	**Fair value**
Corporations and public entities	19,035	35,624	24,752	14,173
Individuals	23,561	37,785	23,129	14,422
Total	**42,596**	**73,409**	**47,881**	**28,595**
Bonds and debt instruments				
Public entities	9,969	19,626	19,145	10,063

*Unaudited financial information representing the carrying amounts of assets and liabilities transferred from SpKef Savings Bank immediately before the acquisition date.

**The cash flows presented in the table above consist of undiscounted principal and interest receivable.

***Eliminations consist of amounts receivable and payable between the Bank and SpKef which have been eliminated upon consolidation of SpKef on acquisition date.

Landsbankinn hf. Consolidated Financial Statements 2011 All amounts are in ISK million

5. Business combinations (continued)

Acquisition of SpKef Savings Bank (continued)

The consideration payable by the National Treasury through a bond to be issued to the Bank is subject to the eventual fair value of financial assets and liabilities assumed from SpKef. The Group recognised a provisional amount of ISK 30,596 million which is presented among "Other assets" in the consolidated statement of financial position.

Acquisition related cost directly attributable to the acquisition amounted to ISK 245 million, all of which was cost for external services. However, acquisition related cost indirectly attributable to the acquisition cannot be estimated reliably, being cost for internal services like salaries of the Bank's employees working on the acquisition. Direct acquisition cost was therefore expensed in the line item "Acquisition-related costs" exclusive of indirect acquisition cost.

Since the acquisition on 7 March 2011, SpKef Savings Bank has contributed total operating income of ISK 1,784 million and profit of ISK 258 million to the Group's results.

Total acquisitions during the period

The table below summarises all assets acquired and liabilities assumed recognised during the year 2011:

Identifiable assets acquired and liabilities assumed	Avant hf.	SpKef Savings Bank	Total
Assets			
Cash and balances with Central Bank	683	1,295	1,978
Bonds and debt instruments	-	10,063	10,063
Equities and equity instruments	-	72	72
Loans and advances to financial institutions	-	1,135	1,135
Loans and advances to customers	9,360	28,595	37,955
Investments in equity-accounted associates	-	234	234
Property and equipment	-	1,613	1,613
Deferred tax assets	1,270	205	1,475
Other assets	23	70	93
Assets classified as held for sale	311	1,993	2,304
Total	**11,647**	**45,275**	**56,922**
Liabilities			
Due to financial institutions and Central Bank	-	(13,885)	(13,885)
Deposits from customers	-	(57,575)	(57,575)
Tax liabilities	-	(74)	(74)
Other borrowings	-	(2,058)	(2,058)
Other liabilities	(1,925)	(2,163)	(4,088)
Total	**(1,925)**	**(75,755)**	**(77,680)**
Total identifiable net assets	**9,722**	**(30,480)**	**(20,758)**
Non-controlling interests	-	(116)	(116)
Fair value of the Bank’s outstanding claim on Avant hf.	(9,722)	-	(9,722)
Provisional amount of the bond to be issued to the Bank by the Icelandic State Treasury	-	30,596	30,596
Goodwill	**0**	**0**	**0**

If all of the business combinations occurring during the period had been as of 1 January 2011, consolidated total operating income contribution would have been ISK 30,692 million and consolidated profit for the period would have been ISK 16,509 million.

Landsbankinn hf. Consolidated Financial Statements 2011 All amounts are in ISK million

6. Operating segments

The business segments are disclosed in accordance with the internal reporting to the CEO and the Board of Directors, who are responsible for allocating resources to the reportable segments and assessing their financial performance.

The Group has seven main business segments:

• **Retail Banking** provides financial services through the Bank's branch network to individuals and to small and medium-size businesses.
• **Vehicle and Equipment Financing** provides leasing services to individuals and businesses.
• **Corporate Banking** provides financial services to large and medium-size corporate clients.
• **Asset Restructuring** provides restructuring solutions to corporate clients who have defaulted on their loans and can be returned to viability.
• **Markets & Treasury,** Markets provide brokerage services in securities, foreign currencies and derivatives, sale of securities issues, money market lending and advisory services. Likewise treasury incorporates unallocated capital, funding, liquidity and interbank functions for the Bank. Treasury manages the Group's market risk.
• **Asset Management** provides a range of wealth and asset management products and services for individuals, corporations and institutional investors.
• **Horn fjárfestingarfélag,** a subsidiary of the Bank, is an investment company which holds shares in most industry sectors.

Other segments comprise of several Group's support functions such as Finance, Risk Management and Corporate Development.

Administrative expenses of Group support functions directly attributable to individual business segments are allocated to appropriated business segments based on the underlying cost drivers. Indirect administrative expenses of cost centres cannot be estimated reliably and are therefore not allocated.

The following table summarizes each segment's financial performance as disclosed in the internal management reports on segments profit before tax. In these reports all income statement items are reported on a net basis, including the total interest income and expense. Inter-segment pricing is determined on an arm's length basis.

No revenue from transactions with a single external customer or counterparty amounted to 10% or more of the Group's total revenue during the period from 1 January 2011 to 31 December 2011.

The Group had a single reportable segment in the year 2010 compared to seven segments in the year 2011. However, comparative information for the seven segments in the year 2010 is not available and is therefore not restated and disclosed in the consolidated financial statements.

6. Operating segments (continued)

1 January - 31 December 2011	Retail Banking	Vehicle and Equipment Financing	Corporate Banking	Asset Restructur-ing	Markets & Treasury	Asset Management	Horn fjárfestingar félag	All Other Segments	Total Segments	Eliminations	Total
Net interest income (expense)	12,004	1,682	9,536	4,957	7,320	15	(1,024)	(291)	**34,199**	(1,550)	**32,649**
Net adjustments in valuation	(10,351)	(14,816)	3,120	(1,095)	(422)	-	-	(23)	**(23,587)**	-	**(23,587)**
Net fee and commission income	2,000	170	386	68	1,067	971	84	(133)	**4,613**	(190)	**4,423**
Net gain (loss) on financial assets designated as at fair value through profit or loss	-	37	5,304	-	1,452	-	10,759	(93)	**17,459**	-	**17,459**
Net gain (loss) on financial assets and liabilities held for trading	(1)	-	-	-	1,448	7	(447)	2	**1,009**	-	**1,009**
Net foreign exchange gain (loss)	-	(439)	-	-	(854)	5	238	-	**(1,050)**	291	**(759)**
Other income and (expenses)	(932)	12	(267)	288	172	(1)	29	252	**(447)**	(3)	**(450)**
Total operating income (expense)	**2,720**	**(13,354)**	**18,079**	**4,218**	**10,183**	**997**	**9,639**	**(286)**	**32,196**	**(1,452)**	**30,744**
Total operating expenses	(11,919)	(1,189)	(2,398)	(2,068)	(2,253)	(1,308)	(268)	(863)	**(22,266)**	210	**(22,056)**
Share of profit of equity-accounted associates, net of income tax	561	-	-	(2)	826	-	-	32	**1,417**	-	**1,417**
Profit (loss) before tax	**(8,638)**	**(14,543)**	**15,681**	**2,148**	**8,756**	**(311)**	**9,371**	**(1,117)**	**11,347**	**(1,242)**	**10,105**
Net revenue (expenses) from external customers	(3,800)	(11,852)	28,809	10,221	(2,892)	960	10,681	69	**32,196**		
Net revenue (expenses) from other segments	6,520	(1,502)	(10,730)	(6,003)	13,075	37	(1,042)	(355)	**0**		
Total operating income (expense)	**2,720**	**(13,354)**	**18,079**	**4,218**	**10,183**	**997**	**9,639**	**(286)**	**32,196**		
Total assets	**486,403**	**24,579**	**365,490**	**123,225**	**558,934**	**3,638**	**29,770**	**7,134**	**1,599,173**	**(463,691)**	**1,135,482**
Total liabilities	**457,545**	**18,246**	**304,513**	**102,452**	**483,429**	**3,156**	**22,454**	**7,134**	**1,398,929**	**(463,691)**	**935,238**
Allocated capital	**28,858**	**6,333**	**60,977**	**20,773**	**75,505**	**482**	**7,316**	**0**	**200,244**	**0**	**200,244**

All amounts are in ISK million

Notes to the Consolidated Statement of Financial Position

7. Classification and fair value of financial assets and liabilities

According to IAS 39, financial assets and liabilities must be classified into specific categories which affect how they are measured after initial recognition. Each category's basis of subsequent measurement is specified below:
• Loans and receivables, measured at amortised cost;
• Financial assets and liabilities held for trading, measured at fair value;
• Financial assets designated as at fair value through profit or loss, measured at fair value;
• Other financial liabilities, measured at amortised cost.

The following table shows the classification of the Group's financial assets and liabilities according to IAS 39 and their fair values as at 31 December 2011:

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount	Fair value
Cash and balances with Central Bank	8,823	-	-	-	-	8,823	8,823
Bonds and debt instruments	112,547	93,063	16,238	-	-	221,848	221,848
Equities and equity instruments	-	1,224	44,813	-	-	46,037	46,037
Derivative instruments	-	159	-	-	-	159	159
Loans and advances to financial institutions	100,133	-	-	-	-	100,133	100,133
Loans and advances to customers	639,130	-	-	-	-	639,130	669,227
Other financial assets	4,321	-	-	-	-	4,321	4,321
Total	**864,954**	**94,446**	**61,051**	**0**	**0**	**1,020,451**	**1,050,548**
Financial liabilities							
Due to financial institutions and Central Bank	-	-	-	112,876	-	112,876	112,876
Deposits from customers	-	-	-	443,590	-	443,590	443,582
Derivative instruments and short positions	-	7,916	-	-	-	7,916	7,916
Secured bonds	-	-	-	277,076	-	277,076	277,076
Contingent bond	-	-	-	-	60,826	60,826	60,826
Other financial liabilities	-	-	-	6,623	-	6,623	6,623
Total	**0**	**7,916**	**0**	**840,165**	**60,826**	**908,907**	**908,899**

The following table shows the classification of the Group's financial assets and liabilities according to IAS 39 and their fair values as at 31 December 2010:

Financial assets	Loans and receivables	Held for trading	Designated as at fair value	Liabilities at amortised cost	Other liabilities at fair value	Total carrying amount	Fair value
Cash and balances with Central Bank	47,777	-	-	-	-	47,777	47,777
Bonds and debt instruments	100,244	43,735	17,580	-	-	161,559	161,559
Equities and equity instruments	-	3,178	26,251	-	-	29,429	29,429
Derivative instruments	-	23	-	-	-	23	23
Loans and advances to financial institutions	91,882	-	-	-	-	91,882	91,882
Loans and advances to customers	592,954	-	-	-	-	592,954	620,403
Other financial assets	7,070	-	-	-	-	7,070	7,070
Total	**839,927**	**46,936**	**43,831**	**0**	**0**	**930,694**	**958,143**
Financial liabilities							
Due to financial institutions and Central Bank	-		-	147,478	-	147,478	147,478
Deposits from customers	-	-	-	371,558	-	371,558	371,558
Derivative instruments and short positions	-	7,119	-	-	-	7,119	7,119
Secured bonds	-	-	-	261,313	-	261,313	261,313
Contingent bond	-	-	-	-	26,510	26,510	26,510
Other financial liabilities	-	-	-	4,237	-	4,237	4,237
Total	**0**	**7,119**	**0**	**784,586**	**26,510**	**818,215**	**818,215**

All amounts are in ISK million

7. Classification and fair value of financial assets and liabilities (continued)

The fair value of financial assets and liabilities was determined based on the following methods and assumptions. For all financial assets and liabilities the foreign currency exchange rates used are from observable markets both for spot and forward contracts and futures in the world's major currencies.

Balances with Central Bank

The carrying amount of balances with Central Bank is a reasonable approximation of their fair value.

Bonds and debt instruments

Quoted prices are generally available for government bonds and certain corporate securities. Where this information is not available, fair value is estimated by adding credit spreads to quoted market rates for similar bonds or relevant interest rate curves.

For bonds issued by defaulting or greatly distressed parties recovery values are used for estimating the fair value. These are published by the defaulting issuers resolution committee or equivalent, estimated based on statement of financial position information or expert opinion.

Interest rates are principally benchmark interest rates such as the London Inter-Bank Offered Rate (LIBOR) and quoted interest rates in the swap, bond and futures markets.

Where available, credit spreads are derived from prices of credit default swaps (CDS) or other credit based instruments, such as debt securities. For others, credit spreads are obtained from pricing services. Counterparty credit spreads are estimated based on the creditworthness of the counterparty when differing from the assumed counterparty in the market.

Equities and equity instruments

Quoted prices are generally readily available for equity shares listed on the world's major stock exchanges and for major indices on such shares. When this information is not available the fair value is estimated based on market prices and earning multiples from similar securities, recent transactions or by using discounted cash flow methods.

Derivative instruments

The fair value of derivative instruments is determined using valuation methods whose most significant inputs is volatility, which are obtained from broker quotations, pricing services or derived from option prices.

Loans and advances to financial institutions

Loans and advances to banks include inter-bank placements and items in the course of collection. The carrying amount of floating rate placements and overnight deposits is a reasonable approximation of their fair value.

Loans and advances to customers

The estimated fair value of loans and advances represents the discounted amount of estimated future cash flows expected to be received based on future recovery of the loans. The recovery rates and loss given default are used as input into valuation models as an indicator of severity of losses on default. The loans are grouped by type and for each loan the estimated cash flows to be received during each month until end of 2011 are estimated and payments after 2011 are estimated to be received at the end of June each year. Expected cash flows are discounted at current market rates to determine fair value. Interest rates are principally benchmark interest rates such as London Inter-Bank Offered Rate (LIBOR), quoted interest rates in the swap, bond and future markets or the Group's current rates for new loans.

Due to financial institutions and Central Bank

Amounts due to financial institutions and Central Bank are repriced at least monthly and therefore their estimated fair value is the same as their carrying amount.

Deposits from customers

The estimated fair value of deposits from customers represents the discounted amount of future cash flows based on contractual maturities. Expected cash flows are discounted at current market rates to determine fair value. Interest rates are principally benchmark interest rates such as Reykjavik Inter-Bank Offered Rate (REIBOR) or quoted interest rates in the bond markets.

Short positions

The short positions are in Icelandic government bonds with readily available quoted market prices.

7. Classification and fair value of financial assets and liabilities (continued)

Secured bonds

The fair value of the secured bonds equals their carrying amount as the bonds have been discounted upon initial recognition at market rate and no significant changes have occurred in the market rate for these secured bonds since initial recognition.

Contingent bond

The fair value of the contingent bond is based on the expected value of the underlying loan portfolios and on how much it will exceed its expected return which is defined as 400 basis points over the relevant interbank rate. The estimate of the expected value is based on log-normal distribution where the minimum payment is ISK 0 and maximum payment is ISK 92 billion. Key input and assumptions used in the valuation model at 31 December 2011 include expected volatility for the loan portfolio of 5.0% (2010: 15%) and a risk free rate of 6.0% (2010: 2.8%). However, the issue and amount of the bond is subject to considerable outperformance of the underlying loan portfolios.

Fair value hierarchy

The Group has used a valuation hierarchy for disclosure of inputs to valuation used to measure fair value. This hierarchy prioritises the inputs into three broad levels as follows:

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

• Level 2: Valuation technique using observable inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and

• Level 3: Valuation technique with significant unobservable inputs for the asset or liability that are not based on observable market data (unobservable inputs). Level 3 includes all instruments that are valued according to quoted prices for similar instruments where significant unobservable adjustments or assumptions are required to reflect the differences between instruments.

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities, carried at fair value in the consolidated statement of financial position, are categorised as at 31 December 2011:

Financial assets	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	69,543	28,155	11,603	109,301
Equities and equity instruments	14,290	3,488	28,259	46,037
Derivative instruments	-	159	-	159
Total	**83,833**	**31,802**	**39,862**	**155,497**

Financial liabilities				
Derivative instruments	-	1,729	-	1,729
Short positions	6,187	-	-	6,187
Contingent bond	-	-	60,826	60,826
Total	**6,187**	**1,729**	**60,826**	**68,742**

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities, carried at fair value in the consolidated statement of financial position, are categorised as at 31 December 2010:

Financial assets	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	20,340	26,933	14,042	61,315
Equities and equity instruments	16,027	2,925	10,477	29,429
Derivative instruments	-	23	-	23
Total	**36,367**	**29,881**	**24,519**	**90,767**

Financial liabilities				
Derivative instruments	-	1,445	-	1,445
Short positions	5,674	-	-	5,674
Contingent bond	-	-	26,510	26,510
Total	**5,674**	**1,445**	**26,510**	**33,629**

During the year 2011 there were no transfers into Level 1. Financial assets were transfers into Level 2 from Level 3 because valuation inputs became observable during the year 2011.

All amounts are in ISK million

Notes to the Consolidated Financial Statements

7. Classification and fair value of financial assets and liabilities (continued)

The following tables show the reconciliation for fair value measurement in Level 3 for the year 2011 and 2010:

1 January - 31 December 2011	Bonds and debt instruments	Equities and equity instruments	Total financial assets	Contingent bond
Carrying amount at 1 January 2011	14,042	10,477	24,519	(26,510)
Total (losses) gains recognised in income statement	(64)	13,097	13,033	(34,316)
Purchases	3,391	4,585	7,976	-
Sales	(2,754)	(7,418)	(10,172)	-
Acquisitions through business combination	48	192	240	-
Settlements	(2,999)	2,936	(63)	-
Reclassification from assets held for sale	-	4,390	4,390	-
Transfers into Level 3	-	-	-	-
Transfers out of Level 3	(61)	-	(61)	-
Carrying amount at 31 December 2011	**11,603**	**28,259**	**39,862**	**(60,826)**
1 January - 31 December 2010				
Carrying amount at 1 January 2010	37,371	3,555	40,926	(10,241)
Total (losses) gains recognised in income statement	(1,342)	11	(1,331)	(16,269)
Purchases	6,433	4,260	10,693	-
Sales	(7,851)	(531)	(8,382)	-
Settlements	(15,368)	3,313	(12,055)	-
Transfers into Level 3	375	-	375	-
Transfers out of Level 3	(5,576)	(131)	(5,707)	-
Carrying amount at 31 December 2010	**14,042**	**10,477**	**24,519**	**(26,510)**

The following tables show the line items in the consolidated income statement where the total gains (losses) were recognised during the year 2011 and 2010, for fair value measurements in Level 3:

1 January - 31 December 2011	Bonds and debt instruments	Equities and equity instruments	Contingent bond	Total
Fair value change of contingent bond	-	-	(34,316)	(34,316)
Net gain on financial assets designated as at fair value through profit or loss	(333)	13,084	-	12,751
Net foreign exchange (loss) gain	269	13	-	282
Total	**(64)**	**13,097**	**(34,316)**	**(21,283)**
1 January - 31 December 2010				
Fair value change of contingent bond	-	-	(16,269)	(16,269)
Net gain on financial assets designated as at fair value through profit or loss	350	185	-	535
Net foreign exchange (loss) gain	(1,692)	(174)	-	(1,866)
Total	**(1,342)**	**11**	**(16,269)**	**(17,600)**

The following table shows the line items in the consolidated income statement where gains (losses), relating only to financial assets and liabilities held by the Group at 31 December 2011 and categorised in Level 3, were recognised:

	Bonds and debt instruments	Equities and equity instruments	Contingent bond	Total
Fair value change of contingent bond	-	-	(34,316)	(34,316)
Net gain on financial assets designated as at fair value through profit or loss	(668)	13,031	-	12,363
Net foreign exchange (loss) gain	391	-	-	391
Total	**(277)**	**13,031**	**(34,316)**	**(21,562)**

All amounts are in ISK million

7. Classification and fair value of financial assets and liabilities (continued)

Although the Group believes that its estimates of fair value are appropriate, the use of different valuation methodologies and assumptions could lead to different measurements of fair value. The following table shows how profit before tax would have been affected if one or more of the inputs for fair value measurements in Level 3 were changed to reasonably possible alternatives:

	Effect on profit before tax	
Financial assets	**Favourable**	**Unfavourable**
Bonds and debt instruments	3,561	(2,552)
Equities and equity instruments	2,826	(2,826)
Total	**6,387**	**(5,378)**
Financial liabilities		
Contingent bond	2,393	(1,251)

The effect on profit was calculated using methods suitable for the models used. For equities valued using comparables or recent transactions the price was changed by +/-10%. For bonds issued by defaulting or greatly distressed parties the recovery value was changed by +/-500 basis points. For the contingent bond the volatility of the value of the underlying assets was changed by +/-250 basis points.

8. Cash and balances with Central Bank

	2011	2010
Cash on hand	2,355	2,058
Reverse repurchase agreements with Central Bank	4,010	43,270
Unrestricted balances with Central Bank	39	482
Total cash and unrestricted balances with Central Bank	**6,404**	**45,810**
Restricted balances with Central Bank	2,419	1,967
Total cash and balances with Central Bank	**8,823**	**47,777**

The Group has entered into short-term reverse repurchase agreements with the Central Bank of Iceland according to which the Group acquired certificates of deposit issued by the Central Bank and committed to resell the certificates to the Central Bank at a fixed price at the end of the contractual period. The Group does not recognise the certificates of deposit as its assets because the Group does not bear substantially all the risks and rewards of ownership of the certificates. However, the Group derecognised the cash transferred to the Central Bank and recognised a receivable from the Central Bank, including accrued interest.

The Bank holds a mandatory reserve deposit account with the Central Bank of Iceland. The average balance of this account for each month must be equivalent to at least mandatory reserve deposits, which amounted to ISK 7,510 million for December 2011 (December 2010: ISK 6,328 million). Any excess balance is available for use by the Group. Other cash and balances with the Central Bank are available for the Group's immediate use.

All amounts are in ISK million

9. Bonds and equities

	2011				2010			
Bonds and debt instruments	Loans and receivables	Held for trading	Designated as at fair value	Total	Loans and receivables	Held for trading	Designated as at fair value	Total
Domestic								
Listed	112,547	30,902	628	144,077	100,244	34,745	2,037	137,026
Unlisted	-	371	13,012	13,383	-	-	12,484	12,484
	112,547	**31,273**	**13,640**	**157,460**	**100,244**	**34,745**	**14,521**	**149,510**
Foreign								
Listed	-	61,790	1,917	63,707	-	8,989	1,690	10,679
Unlisted	-	-	681	681	-	-	1,370	1,370
	0	**61,790**	**2,598**	**64,388**	**0**	**8,989**	**3,060**	**12,049**
Total bonds	**112,547**	**93,063**	**16,238**	**221,848**	**100,244**	**43,734**	**17,581**	**161,559**
Equities and equity instruments								
Domestic								
Listed	-	256	9,277	9,533	-	199	10,129	10,328
Unlisted	-	-	27,836	27,836	-	-	10,023	10,023
	0	**256**	**37,113**	**37,369**	**0**	**199**	**20,152**	**20,351**
Foreign								
Listed	-	968	3,777	4,745	-	2,979	5,892	8,871
Unlisted	-	-	3,923	3,923	-	-	207	207
	0	**968**	**7,700**	**8,668**	**0**	**2,979**	**6,099**	**9,078**
Total equities	**0**	**1,224**	**44,813**	**46,037**	**0**	**3,178**	**26,251**	**29,429**
Total bonds and equities	**112,547**	**94,287**	**61,051**	**267,885**	**100,244**	**46,912**	**43,832**	**190,988**

Bonds and equities are classified as "domestic" or "foreign" according to the country of incorporation of the issuer.

Bonds and debt instruments classified as loans and receivables as at 31 December 2011 and 2010 consist of part of the government bonds which the Bank received in settlement of the capital contribution in 2009. The bonds were listed on the OMX Stock Exchange in Iceland during 2010.

10. Derivative instruments and short positions

	2011			2010		
	Notional	Fair value		Notional	Fair value	
Foreign exchange derivatives	amount	Assets	Liabilities	amount	Assets	Liabilities
Currency forwards	70,297	143	1,262	22,359	20	769
Cross-currency interest rate swaps	1,715	-	450	1,897	-	659
OTC currency options	-	-	-	20,424	0	-
	72,012	**143**	**1,712**	**44,680**	**20**	**1,428**
Interest rate derivatives						
Total return swaps	5,834	16	17	3,294	3	17
	5,834	**16**	**17**	**3,294**	**3**	**17**
Short positions - listed bonds	**-**	**-**	**6,187**	**-**	**-**	**5,674**
Total	**77,846**	**159**	**7,916**	**47,974**	**23**	**7,119**

The Group uses derivatives both for hedging and trading purposes.

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11. Loans and advances to financial institutions

	2011	2010
Bank accounts with financial institutions	7,221	6,844
Money market loans	79,407	63,549
Overdrafts	3,857	6,844
Other loans	9,648	16,823
Less: Allowance for impairment	-	(2,178)
Total	**100,133**	**91,882**

12. Loans and advances to customers

	2011	2010
Public entities	12,143	13,928
Individuals	186,033	166,069
Corporations	469,374	434,079
Less: Allowance for impairment	(28,420)	(21,122)
Total	**639,130**	**592,954**

During the reporting period the Group was not permitted to sell or repledge any collateral in absence of default by the owner of the collateral.

Further disclosures on loans and advances are provided in the risk management section of the notes.

13. Investments in associates

Investments in equity-accounted associates	2011	2010
Carrying amount at the beginning of the year	3,340	2,945
Acquisitions through business combination	234	-
Acquisitions	6,778	104
Share of profit of equity-accounted associates, net of income	1,417	291
Disposals	(91)	-
Total	**11,678**	**3,340**

At 31 December 2011	Total assets	Total liabilities	Profit (loss)	Ownership interest	Share of profit of associates	Carrying amount
Valitor Holding hf.	39,608	32,231	1,218	38%	463	2,803
Framtakssjóður Íslands slhf.	28,153	605	2,344	28%	839	7,600
Borgun hf.	16,075	14,677	210	31%	66	455
Reiknistofa bankanna hf.	1,979	361	166	37%	32	596
Motus ehf.	646	276	82	40%	32	181
Auðkenni hf.	222	51	4	20%	-	34
Other	-	-	-	-	(15)	9
Total	**86,683**	**48,201**	**4,024**		**1,417**	**11,678**

At 31 December 2010						
Valitor Holding hf.	43,543	37,385	1,014	38%	385	2,340
Kredikort hf.	7,206	6,654	(299)	20%	(60)	111
Borgun hf.	15,394	14,188	191	20%	38	241
Reiknistofa bankanna	1,699	248	-	34%	-	515
Intrum hf. (Motus ehf)	615	293	7	33%	(1)	96
Auðkenni hf.	222	51	4	20%	-	34
Other	-	-	-	-	(71)	3
Total	**68,679**	**58,818**	**917**		**291**	**3,340**

The Group has two investments in associates which are accounted for in their entirety by the Group as financial assets designated as at fair value through profit or loss and presented in the consolidated statement of financial position in the line "Equities and equity instruments". These investments are 25.0% shareholding in Eyrir Invest ehf. and 49.5% shareholding in Promens hf.

All associates are unlisted companies.

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14. Property and equipment

	2011			2010		
	Buildings	Fixtures, equipment and vehicles	Total	Buildings	Fixtures, equipment and vehicles	Total
Carrying amount at the beginning of the year	3,299	1,717	5,016	3,447	2,583	6,030
Acquisitions through business combination	1,329	284	1,613	-	-	-
Additions during the year	2	375	377	5	86	91
Sold during the year	-	(3)	(3)	(75)	(4)	(79)
Disposals	-	(68)	(68)	-	-	-
Depreciation	(99)	(399)	(498)	(78)	(948)	(1,026)
Carrying amount at 31 December	**4,531**	**1,906**	**6,437**	**3,299**	**1,717**	**5,016**
Gross carrying amount	4,789	4,375	9,164	3,458	3,786	7,244
Accumulated depreciation	(258)	(2,469)	(2,727)	(159)	(2,069)	(2,228)
Carrying amount at 31 December	**4,531**	**1,906**	**6,437**	**3,299**	**1,717**	**5,016**
Depreciation rates	2-4%	10-33%		2-4%	10-33%	

Official assessment value of buildings at 31 December	**2011**	**2010**
Official assessment value used for tax purposes	3,823	3,732
Replacement value used for insurance purposes	8,774	7,142

Depreciation and amortisation presented in the income statement consists of:	**2011**	**2010**
Depreciation of property and equipment	498	1,026
Amortisation of intangible assets	273	285
Total	**771**	**1,311**

15. Intangible assets

Computer software licenses	**2011**	**2010**
Carrying amount at the beginning of the year	877	1,058
Additions	77	104
Amortisation	(273)	(285)
Carrying amount at 31 December	**681**	**877**
Amortisation rates	20-33%	20-33%
Gross carrying amount	1,508	1,431
Accumulated amortisation	(827)	(554)
Carrying amount at 31 December	**681**	**877**

16. Other assets

	2011	**2010**
Provisional amount of the bond to be issued by the National Treasury*	30,596	-
Legally disputed collections**	3,666	3,669
Unsettled securities trading	1,848	3,168
Receivable from Framtakssjóður Íslands slhf.	600	-
Receivable from Landsbanki Íslands hf.	470	688
Other accounts receivable	1,403	3,214
Sundry assets	5,418	7,226
Total	**44,001**	**17,965**

*The provisional amount of the bond to be issued by the Icelandic State Treasury is due to the acquisition of SpKef Savings Bank as disclosed in Note 5.

**See note 42

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17. Assets and liabilities classified as held for sale

Assets classified as held for sale	2011	2010
Repossessed collateral	51,711	43,831
Assets of disposal groups classified as held for sale	1,841	84,958
Total	**53,552**	**128,789**

Repossessed collateral

Repossessed collateral consists mainly of property and equipment resulting from collateral foreclosed by the Group as security for loans and advances. The Group's policy is to pursue timely realisation of the repossessed collateral in an orderly manner. The Group generally does not use the non-cash repossessed collateral for its own operations. The repossessed collateral is recognised as assets of either the Bank or its subsidiaries Reginn ehf. and Hömlur hf. The subsidiary Reginn hf. is in the process of listing its common shares on the OMX Nordic Exchange in Iceland. The preparation of the listing started in the year 2011 and the listing is expected to be completed during the second quarter of 2012.

Repossessed collateral	2011	2010
Carrying amount at the beginning of the year	43,831	27,317
Acquisitions through business combination	2,304	-
Repossessed during the period	22,668	25,465
Disposed during the period	(11,730)	(8,951)
Reclassification to equities and equity instruments	(4,390)	-
Impairment	(972)	-
Carrying amount at the end of the year	**51,711**	**43,831**

Assets of disposal groups classified as held for sale

Assets of disposal groups classified as held for sale consist of all the assets and liabilities of subsidiaries acquired by the Bank exclusively with a view to resale (i.e. Eignarhaldsfélagið Vestia ehf., Icelandic Group hf., Vörður líftrygging ehf. and their subsidiaries).

The profit (loss) for the year from discontinued operations which is presented in the consolidated income statement consists only of the results of those subsidiaries acquired by the Bank exclusively with a view to resale as they meet the definition of discontinued operations in IFRS 5.

On 20 January 2011 the Bank finalised the sale to Framtakssjóður Íslands slhf. (FSÍ) of 100% shareholding in its subsidiary Eignarhaldsfélagið Vestia ehf. (Vestia), comprising a 62% shareholding in Teymi hf., 100% shareholding in Húsasmiðjan ehf. and 100% shareholding in Plastprent ehf., and 100% shareholding in two tranches in its subsidiary Icelandic Group hf. (IG). The sale price for the shares in Vestia amounted to ISK 4,000 million and for the shares in IG amounted to ISK 13,900 million.

The Icelandic Competition Authority approved the sale of Vestia and IG on 14 January 2011, with certain conditions. The Bank delivered the shares to FSÍ on 20 January 2011. The Group recognised a gain of ISK 5.3 billion on the disposal of these shares in the line item "Profit for the year from discontinued operations, net of income tax" in the year 2011.

As part of the agreement with FSÍ, the Bank committed itself to invest up to ISK 15.0 billion in FSÍ. This amount will be callable during the years 2011-2016 as needed to fund investments by FSÍ, in proportion to the Bank's holding in FSÍ. The maximum amount that the Bank can invest in FSÍ is limited by 25% exposure to the equity of the Bank. At 31 December 2011 the Bank had invested in FSÍ ISK 7,508 million representing 27.6% of total called in commitments (ISK 27,215 million). FSÍ is required to redeem its shareholders with the proceeds from sales of assets.

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18. Due to financial institutions and Central Bank

	2011	2010
Loans and repurchase agreements with Central Bank	40	80
Loans and deposits from financial institutions	112,836	147,398
Total	**112,876**	**147,478**

19. Deposits from customers

	2011	2010
Demand deposits	344,952	271,977
Time deposits	98,638	99,581
Total	**443,590**	**371,558**

The increase in deposits is mostly due to the acquisition of SpKef hf. (See note 5).

20. Secured bonds

	Nominal amount				Carrying amount	
	Foreign	ISK		Contractual	ISK	
Secured bonds	currency	2011	2010	interest rate (%)	2011	2010
EUR	871 million	138,281	133,960	EURIBOR + 1.75/2.90	136,818	130,963
GBP	275 million	52,330	49,250	LIBOR + 1.75/2.90	51,702	48,132
USD	734 million	89,741	84,179	LIBOR + 1.75/2.90	88,556	82,218
Total		**280,352**	**267,389**		**277,076**	**261,313**

On 12 October 2010 the Bank issued secured bonds to Landsbanki Íslands hf. as part of the acquisition price for its Icelandic operations. These bonds are denominated in EUR, GBP and USD and carry interest from October 2008. The carrying amount of the bonds as at 31 December 2011 and 2010 assumes the effective interest of EURIBOR/LIBOR+2,90% to maturity. The bonds are secured by pools of loans to customers (see Note 38).

The bonds mature in October 2018 with quarterly installments starting in 2014. The interest rates are 3 months EURIBOR for the EUR-denominated bond and 3 months LIBOR for the GBP and USD-denominated bonds, plus a margin of 1.75% for the first 5 years and a margin of 2.90% for the remaining 5 years. The first interest payment date was on 12 October 2010. From 30 June 2010, bondholders have had the right to require the Bank to convert the bonds into Eurobonds. Upon such conversion, the Bank will make reasonable endeavours to list such Eurobonds on a qualified stock exchange, as soon as feasible following conversion. The bondholders have not yet exercised their right to require the Bank to convert the bonds into Eurobonds.

21. Contingent bond

According to the provisions of the settlement agreement signed on 15 December 2009, the Bank might have to issue to Landsbanki Íslands hf. a bond on 31 March 2013 as an additional consideration for the assets and liabilities transferred from Landsbanki Íslands hf. on 9 October 2008. The contingent bond can have a nominal amount of up to ISK 92 billion, with the amount being contingent on whether the value of certain pools of assets, to be determined as at 31 December 2012, exceeds the future value of the acquisition price of those assets agreed for as at 9 October 2008, subject to specified adjustments. The value will be determined by a third-party valuation agent based on agreed-upon valuation procedures. The additional value at year-end 2012 that might exceed the future value of the 2008 acquisition price would be divided between Landsbanki Íslands hf., which would be assigned 85% (though no higher than ISK 92 billion) and the Bank, 15%. If issued, this bond would be denominated in EUR or such other currencies as may be agreed between the Bank and Landsbanki Íslands hf., whereby the ISK nominal amount would be converted into EUR using the exchange rate at 31 December 2012. The bond would bear floating interest rate and it would mature in October 2018 with quarterly installments starting in 2014.

The contingent obligation of the Bank is classified as a financial liability and measured initially at fair value. Subsequently, it is measured at fair value, with any resulting gain or loss recognised in the line item "Fair value change of contingent bond" in the consolidated income statement.

All amounts are in ISK million

22. Tax assets and liabilities

Tax assets and liabilities are specified as follows:

Tax assets	2011	2010
Deferred tax assets	3,003	1,522
Tax liabilities		
Current tax liabilities	70	1,979
Deferred tax liabilities	-	-
Total	**70**	**1,979**

Recognised deferred tax assets and liabilities are attributable to the following:

	2011			2010		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Property and equipment	-	(1,332)	(1,332)	-	(1,943)	(1,943)
Investments in associates	-	(17)	(17)	-	(101)	(101)
Loans and advances to customers	3,640	-	3,640	4,301	-	4,301
Other assets	-	-	0	-	(43)	(43)
Deferred foreign exchange differences	-	(1,259)	(1,259)	-	(1,714)	(1,714)
Other items	-	(348)	(348)	-	(168)	(168)
Tax losses carried forward	2,319	-	2,319	1,190	-	1,190
	5,959	**(2,956)**	**3,003**	**5,491**	**(3,969)**	**1,522**
Set-off of deferred tax assets together with liabilities of the same taxable entities	(2,956)	2,956	-	(3,969)	3,969	-
Total	**3,003**	**0**	**3,003**	**1,522**	**0**	**1,522**

The deferred tax assets and liabilities are measured based on the tax rates and tax laws enacted by the end of 2011, according to which the domestic corporate income tax rate was 20% as at 31 December 2011 (2010: 20%).

The movements in temporary differences during the period were as follows:

		Recognised in income statement		
2011	Balance 1.1	Tax (expense) income	Changes from prior year	Balance 31.12
Property and equipment	(1,943)	589	22	(1,332)
Investments in associates	(101)	96	(12)	(17)
Loans and advances to customers	4,302	(661)	-	3,641
Other assets	(43)	43	-	0
Deferred foreign exchange differences	(1,714)	452	3	(1,259)
Other items	(168)	(167)	(13)	(348)
Tax losses carried forward	1,189	2,478	(1,349)	2,318
Total	**1,522**	**2,830**	**(1,349)**	**3,003**
2010				
Property and equipment	(2,342)	399	-	(1,943)
Investments in associates	(140)	39	-	(101)
Loans and advances to customers	6,383	(2,081)	-	4,302
Other assets	(68)	25	-	(43)
Deferred foreign exchange differences	357	(2,071)	-	(1,714)
Other items	(253)	85	-	(168)
Tax losses carried forward	2,745	(2,198)	642	1,189
Total	**6,682**	**(5,802)**	**642**	**1,522**

All amounts are in ISK million

23. Other liabilities

	2011	2010
Excess payments on lease and loan agreements	11,156	7,182
Unsettled securities trading	4,852	2,730
Withholding tax	2,165	2,893
Accounts payable	1,348	826
Contribution to the Depositors' and Investors' Guarantee Fund	348	680
Tax on liabilities of financial institutions	35	400
Sundry liabilities	3,595	3,990
Total	**23,499**	**18,701**

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

Contribution to the Depositors' and Investors' Guarantee Fund

According to Act No. 98/1999 on Deposit Guarantees and Investor Compensation Schemes ("the Act") and the amendment of the Act from 31 May 2011, the Bank was required during the year 2011 to make a non-refundable general and variable quarterly contributions to the Depositors' and Investors' Guarantee Fund ("the Fund"). The amount of the general contributions was determined on a quarterly basis as the amount equivalent to 0.075% of all guaranteed deposits in the Bank, as defined in the amendment of the Act from 31 May 2011. The amount of the variable contributions was determined on a quarterly basis based on the risk rating of the Bank by the Icelandic Financial Supervisory Authority in Iceland (FME). The general and variable contributions become payable in the event of the Fund's total assets do not reach a minimum of 1% of the amount of guaranteed deposits in commercial banks and savings banks in the preceding year . In addition to the general and variable contributions, the Fund must demand that the Bank make additional contributions to the Fund if so commonly proposed by the FME and the Central Bank of Iceland. Furthermore, the Fund is allowed to demand additional contributions from the Bank in order for the Fund to repay its borrowings and related costs. The maximum amount of additional contributions that the Bank may be required to make to the Fund is the amount equivalent to 0.6% of guaranteed deposits in the Bank.

The Bank's management has concluded that the amount to be recognised as a liability in respect of the general and variable contribution shall only equal the amount that the Bank has no realistic alternative but to settle at each reporting date in accordance with the Act. This is the amount to be paid by the Bank during the following quarter, in respect of the preceding quarter. Other regular contributions to be made by the Bank to the Fund in future quarters do not exist independent of the Bank's future actions and therefore do not represent a present obligation of the Bank at the reporting date. Accordingly, they are not recognised as part of the liability towards the Fund. Therefore, the amount recognised as liability as at 31 December 2011 amounts to ISK 348 million to be paid no later than 1 March 2012 (31 December 2010: ISK 680 million).

In respect of additional contributions to the Fund and the declaration of liability of the Bank , the management of the Bank has concluded that a liability should be recognised in the statement of financial position at each reporting date only if an outflow of Bank resources is deemed at the respective reporting date as being more likely than not to occur. The Bank issued its first declaration of liability to the Fund in November 2009, for a maximum amount of ISK 3,769 million, of which no more than ISK 1,610 million may be requested as a special contribution to the Fund according to the Act. The last declaration of liability which the Bank issued was the one issued in the year 2010 for a maximum amount of ISK 3,851 million, of which no more than ISK 1,611 million may be requested as a special contribution to the Fund according to the Act. This declaration of liability was the only one outstanding as at 31 December 2010 and 31 December 2011. The Bank did not recognise any liability in its consolidated financial statements in respect of this declaration of liability. The Bank did not issue a new declaration of liability between 31 December 2011 and the date when these consolidated financial statements are authorised for issue.

The total general and variable contributions payable by the Bank to the Depositors' and Investors' Guarantee Fund for the year ended 31 December 2011 amounted to ISK 1,352 million. However, the amount recognised by the Group as an expense for the same period is ISK 583 million . The difference between the total amount payable and the amount expensed in the consolidated income statement is due to overestimation of the liability towards the Fund and the related expense for the year ended 31 December 2010.

Tax on liabilities of financial institutions

On 27 December 2010 the Parliament of Iceland passed a bill (Act no. 155/2010 on special tax on financial institutions) according to which certain types of financial institutions must pay annually a tax calculated as 0.041% of the carrying amount of their liabilities as determined for tax purposes. Additional tax of 0.0875% on the same tax base was imposed in respect of the years 2011 and 2012. The total additional tax in respect of the year 2011 amounts to ISK 1,245 million. The additional tax was recognized in the consolidated financial statements of the Group for the year 2011.

All amounts are in ISK million

24. Equity

Share capital

The total number of ordinary shares authorised and issued by the Bank at year-end 2011 and 2010 was 24 billion shares, with par value of ISK 1 per share. One vote is attached to each share of one ISK and the holders of ordinary shares are entitled to one vote per share at general meetings of the Bank. All issued shares are fully paid.

Restriction of dividend payments

As part of the acquisition price for the Icelandic operations of Landsbanki Íslands hf., the Bank issued senior secured bonds (see Notes 20 and 38). If the Bank makes any dividend payments, it shall thereby redeem the bond on a pro-rata basis in amounts equal to the dividend payments. The bonds mature in 2018.

According to the Company Act No. 2/1995, it is only permissible to allocate as dividend profit in accordance with approved annual financial statements for the immediate past financial year, profit brought forward from previous years and free funds after deducting loss which has not been met and the funds which according to laws or Articles of Association must be contributed to a reserve fund or for other use.

Share premium

Share premium represents the difference between the ISK amount received by the Bank when issuing share capital and the nominal amount of the shares issued, less costs directly attributable to issuing the new shares, net of any related tax benefit.

Statutory reserve

The statutory reserve is created in accordance with requirements of the Company Act No. 2/1995, according to which at least 10% of the profit of the Bank, which is not devoted to meeting losses of previous years and is not contributed to other legally stipulated reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital of the Bank. When that limit has been reached the contribution to the statutory reserve must be at a minimum 5% until the reserve amounts to a quarter of the share capital of the Bank.

Retained earnings

Retained earnings consist of undistributed profits and losses accumulated by the Group since the foundation of the Bank, less transfers to the statutory reserve of the Bank.

Notes to the Consolidated Income Statement

25. Net interest income

Interest income	2011	2010
Cash and balances with Central Bank	1,186	3,424
Bonds and debt instruments classified as loans and receivables	3,768	6,643
Loans and advances to financial institutions	938	1,290
Loans and advances to customers	54,672	49,644
Other interest income	267	59
Total	**60,831**	**61,060**

Interest expense		
Due to financial institutions and Central Bank	(2,139)	(4,901)
Deposits from customers	(15,225)	(18,897)
Secured bonds	(10,653)	(12,464)
Other interest expense	(165)	(112)
Total	**(28,182)**	**(36,374)**

Net interest income	**32,649**	**24,686**
Interest spread (as the annualised ratio of net interest income to the average carrying amount of total assets during the year).	**2.9%**	**2.3%**
Adjusted interest spread (as the annualised ratio of net interest income after net adjustments in valuation to the average carrying amount of total assets during the year).	**0.8%**	**2.4%**

All the interest income and interest expense disclosed above is from financial assets and financial liabilities that are not carried at fair value through profit or loss.

26. Net valuation change in loans and advances

	2011	2010
Net adjustments to loans and advances acquired at deep discount	58,489	49,702
Loss from foreign currency linkage of loans and advances to customers	(40,726)	(18,157)
Net impairment loss on loans and advances	(7,034)	(14,636)
Total	**10,729**	**16,909**

Individuals	(14,920)	(6,485)
Corporations	25,649	23,394
Total	**10,729**	**16,909**

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27. Net fee and commission income

Fee and commission income	2011	2010
Investment banking and capital markets	1,287	1,085
Asset management	1,022	757
Lending	981	935
Cards	1,385	1,204
Interbank clearing	991	870
Collection and payment services	790	673
Foreign trade	524	412
Other commissions and fees	457	356
Total	**7,437**	**6,292**

Fee and commission expense		
Investment banking and capital markets	(252)	(259)
Interbank clearing	(988)	(857)
Other fees	(1,774)	(1,594)
Total	**(3,014)**	**(2,710)**

Net fee and commission income	**4,423**	**3,582**

The net fee and commission income above excludes amounts that are otherwise included in determining the effective interest rate for financial assets and liabilities that are not at fair value through profit or loss. More over, it does not include any net fee and commission income relating to such financial assets and liabilities.

28. Net gain on financial assets designated as at fair value through profit or loss

	2011	2010
Bonds and debt instruments	1,319	571
Equities and equity instruments	16,140	5,788
Total	**17,459**	**6,359**

29. Net gain on financial assets and liabilities held for trading

	2011	2010
Bonds and debt instruments	1,749	2,338
Equities and equity instruments	(388)	465
Derivative instruments	(352)	(267)
Total	**1,009**	**2,536**

30. Dividend income

Dividend income was recognised in the consolidated income statement in the following line items:

	2011	2010
Net gain on financial assets designated as at fair value through profit or loss	488	558
Net gain on financial assets and liabilities held for trading	110	25
Total	**598**	**583**

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31. Net foreign exchange (loss) gain

Assets	2011	2010
Cash and balances with Central Bank	7	(130)
Bonds and debt instruments	3,315	(3,580)
Equities and equity instruments	168	(652)
Derivative instruments	(2,772)	(4,436)
Loans and advances to financial institutions	2,797	(6,053)
Loans and advances to customers	12,729	(14,853)
Other assets	192	(89)
Total	**16,436**	**(29,793)**

Liabilities		
Due to financial institutions and Central Bank	167	1,924
Deposits from customers	(5,047)	5,757
Secured bonds	(12,308)	36,721
Other liabilities	(7)	14
Total	**(17,195)**	**44,416**
Net foreign exchange (loss) gain	**(759)**	**14,623**

The foreign exchange differences which were recognised during the year 2011 in the consolidated income statement and arose on financial instruments not measured at fair value through profit or loss, amounted to a ISK 15,725 million gain for financial assets (2010: loss of ISK 21,125 million) and loss of ISK 17,188 million for financial liabilities (2010: gain of ISK 44,403 million). As disclosed in Note 76, the impact of FX-delta has become negligible and the FX-delta is not applicable any longer. Consequently, the Group has not accounted for any amount of foreign exchange difference arising on loans and advances to customers, which is deemed to be uncollectible and is therefore offset by the FX-delta ratio, for the year 2011 (2010: loss of ISK 3,035 million).

32. Other income and expenses

	2011	2010
Recharged expenses	324	479
(Loss) on sale of property and equipment	(61)	(18)
(Loss) on repossessed collateral	(1,030)	(2,534)
Other	317	496
Total	**(450)**	**(1,577)**

33. Salaries and related expenses

	2011	2010
Salaries	9,618	7,497
Contributions to defined contribution pension plans	1,320	1,020
Other personnel expenses	1,052	814
Total	**11,990**	**9,331**
Number of full-time equivalent positions at year-end	1,311	1,146
Average number of full-time equivalent positions during the year	1,283	1,139

All amounts are in ISK million

34. Other operating expenses

	2011	2010
Software licensing and other information technology costs	2,067	1,404
Real estate and fixtures	967	909
Advertising and marketing	739	433
Operating lease rentals	553	495
FME supervisory expenses	335	204
Contribution to the Debtor's Ombudsman	182	-
Audit and related services	178	173
Other professional services	884	685
Other operating expenses	2,562	2,329
Total	**8,467**	**6,632**

Audit and related services	2011	2010
Audit of financial statement and audit related service	121	110
Review of interim financial statement	54	61
Other services	3	2
Total	**178**	**173**

35. Acquisition-related costs

	2011	2010
Cost of acquisition of assets and liabilities from SpKef hf.	245	-
Cost of acquisition of assets and liabilities from Landsbanki Íslands hf.	-	542
Total	**245**	**542**

36. Income tax

Income tax is recognised based on the tax rates and tax laws enacted by the end of the year, according to which the domestic corporate income tax rate was 20.0% (2010: 18.0%).

Income tax recognised in the income statement is specified as follows:

	2011	2010
Current tax expense	(70)	(1,979)
Effect of increase in income tax rate	-	164
Difference of prior year's imposed and calculated income tax	913	-
Deferred tax expense	568	(5,967)
Total	**1,411**	**(7,782)**

The tax on Group profits differs to the following extent from the amount that would theoretically arise by the domestic corporate income tax rate:

	2011		2010	
Profit before tax		10,105		32,644
Tax on liabilities of financial institutions		(814)		(400)
Profit before income tax		9,291		32,244
Income tax calculated using the domestic corporate income tax rate	20.0%	(1,858)	18.0%	(5,804)
Effect of increase in tax rate	0.0%	(4)	(0.5%)	164
Income not subject to tax	(33.2%)	3,080	(5.1%)	1,641
Non-deductable expenses	1.3%	(118)	6.5%	(2,099)
Other	(3.3%)	311	5.2%	(1,684)
Effective income tax	**(15.2%)**	**1,411**	**24.1%**	**(7,782)**

All amounts are in ISK million

Other notes

37. Litigation

Other than claims and legal proceedings that arise from time to time in the ordinary course of business, the Group has no pending legal proceedings other than the following:

Legal proceedings concerning the foundation of the Bank

1) In December 2009 documents were served on Landsbankinn by Basler Kantonalbank (BKB), a bank of the Swiss canton Basel City. The subpoena was filed with the Commercial Court of the Swiss canton Zurich which subsequently ruled that it has jurisdiction in the matter. BKB's claim amounts to ISK 2,511 million (CHF 19.2 million) plus 5% interest since 9 October 2008, and is for the non-performance of FX Swap transactions by Landsbanki Íslands hf. BKB argues that according to an FME decision, the Bank took over Landsbanki Ísland hf. rights and obligations according to derivatives contracts. BKB also argues that the FME decision of 12 October 2008, whereby the decision of 9 October was amended so that derivative contracts were not transferred to the Bank, should be interpreted to apply only to derivative contracts after 12 October 2008. The Bank takes the view that the claim is without merit and should be directed at Landsbanki Íslands hf. and will defend its position before the court in Zurich later this year.

2) In September 2009, Handelsbanken AB, a Swedish bank, commenced litigation before the District Court of Reykjavík against the Bank, demanding a payment of ISK 755 million (SEK 42.4 million) plus interest. The claim was based on a sub-guarantee issued by Landsbanki Íslands hf. to the plaintiff in 2003. In 2007, the guarantee was extended to 2013, and the court claim is that according to the decision of 9 October 2008 by the FME, on the disposal of assets and liabilities of Landsbanki Íslands hf., the Bank is now obliged to pay according to this guarantee. The Bank has responded by stating that according to an Financial Supervisory Authority in Iceland (FME) decision of 19 October 2008, the sub-guarantee in question was actually not transferred from Landsbanki Íslands hf. to the Bank. Even though the Bank believes that the claim is without merit and should be directed at Landsbanki Íslands hf., the final resolution of this matter cannot yet be determined. The District Court of Reykjavík has rendered its ruling in the legal proceeding between the Bank and Handelsbanken AB. The decision was in favor of the Bank and confirmed that the sub-guarantee in question was actually not transferred from Landsbanki Íslands hf. to the Bank by FME decision of 19 October 2008. Handelsbanken AB appealed the ruling of the District Court to the Supreme Court and the proceedings before the court was scheduled 7 February 2012.

3) In March 2009 Aresbank, a Spanish bank, commenced litigation against the Bank, submitting claims to the District Court of Reykjavík. Aresbank demanded that the Bank pay ISK 4,764 million (EUR 30 million) and ISK 1,332 million (GBP 7 million), in addition to interests and litigation costs. Alternatively, the Financial Supervisory Authority of Iceland (FME) and the Icelandic government were subpoenaed for the acknowledgment of their obligation to pay damages on the basis of tort. The case involves two money market loans which each amount to ISK 2,382 million (EUR 15 million) and have reached maturity. In addition, the case involves a third money market loan amounting to ISK 1,332 million (GBP 7 million). In short, Aresbank claims that money market loans are to be considered deposits according to the Act on Deposit Insurance, No. 98/1999. Aresbank cites the Icelandic government‘s declaration from 6 October 2008, which states that the Icelandic government insures all deposits in domestic commercial banks and their branches in Iceland. On 22 December 2010 the District Court of Reykjavík ruled in the case between Aresbank and the Bank. The Court ruled in favor of the Bank and confirmed that money market loans are not deposits according to the Act on Deposit Insurance, No. 98/1999. Aresbank appealed the ruling to the Supreme Court which subsequently requested an advisory opinion from the EFTA court. The request mainly regarded the interpretation of the notion "deposit" in article 1(1) of directive 94/19/EC on deposit-guarantee schemes and if "money market loans" fall there within. The deadline to turn in written arguments and documents is 19 March 2012 which will be followed by oral argumentations and it is foreseeable that the court’s opinion will be published later this year.

Legal proceedings concerning the Bank's subsidiary Landsvaki hf.

4) The City of Reykjavík commenced litigation against Landsvaki hf (a subsidiary of the Bank)., submitting claims to the District Court of Reykjavík. The claim of City of Reykjavík amounts to ISK 1,2 billion plus interest. On 6 October 2008, the Icelandic parliament Althingi adopted Act No. 125/2008, which authorized the Financial Supervisory Authority to assume the powers of the shareholders’ meetings and Board of Directors of financial undertakings and to appoint Resolution Committees for them. A Resolution Committee was appointed for Landsbanki Íslands hf. on 7 October 2008. Landsvaki's money-market-fund "Peningabréf ISK" was closed in compliance with the Financial Supervisory Authority in Iceland (FME) decision on 6 October 2008. Landsvaki subsequently dissolved all money market funds under management by the company in cooperation with the authorities. The disbursement ratio of "Peningabréf ISK" was 68.8% and the City of Reykjavík received their deposit accordingly. The claim is that Landsvaki should compensate the 31.2% (ISK 1,2 billion). On behalf of City of Reykjavík it is claimed that an order to sell was placed with Landsvaki on Friday 3 October 2008 and the transaction should have gone through before the fund was closed on Monday 6 October 2008. It is foreseeable that the case will be brought before the District Court of Reykjavík in the early months of 2012.

37. Litigation (continued)

5) The Bank's subsidiary Landsvaki hf. has received a notice from the Winding-up Board of Landsbanki Íslands hf. (the old bank) regarding its intension, based on Act on Bankruptcy etc. no. 21/1991, to invalidate the purchase of the old bank of bonds from money market funds and recover the funds for the benefit of the estate. The transactions in question are dated back to 1 and 3 October 2008 and amount to approximately ISK 20 billion. Landsvaki protested the notice on the grounds that the procedure is wrongfully directed at Landsvaki who has no standing in the case. Furthermore it was emphasized that Landsvaki has acted not only in accordance with law but also in collaboration with the Financial Supervisory Authority in Iceland (FME). Landsvaki therefore objected all claims made by the Winding-up Board.

The maximum exposure to loss for the Bank arising from litigations against Landsvaki hf. cannot exceed the equity of Landsvaki hf. (ISK 516 million at year end 2011).

Investigations by the EFTA Surveillance Authority (ESA)

6) On 8 September 2010 the EFTA Surveillance Authority (ESA) opened a formal investigation on alleged state aid granted by the Icelandic State to investment funds and associated fund management companies connected to the three failed Icelandic banks Glitnir, Kaupthing and Landsbanki Íslands. It is alleged that in the autumn of 2008, the Icelandic authorities intervened in the market for investment funds that operated in accordance with Act No 30/2003 on Undertakings for Collective Investment in Transferable Securities. Landsvaki has given comments on the issue as Landsvaki's money market funds are among the funds in question. Landsvaki objected the claim. ESA has not yet concluded its investigation.

7) On 15 December 2010 EFTA Surveillance Authority (ESA) opened a formal investigation into state aid granted in October 2008 and September 2009 to rescue domestic operations of the three main Icelandic banks; Glitnir, Kaupthing and Landsbanki Íslands. ESA has not yet concluded its investigation.

8) On 16 September 2011 Arion bank hf. lodged a complaint to EFTA Surveillance Authority (ESA) on the grounds of an alleged infringement of the ESA state aid rules claiming that Landbankinn through state resources has an advantage on the market. It was claimed that the Bank distributed funds among its customers through debt relief measures instead of allocating them to shareholders therefore not operating in accordance with the "market investor principle". The Bank has responded to the complaint and rejected the allegations. ESA has not yet concluded its assessment of the complaint.

Other legal proceedings

9) Norðurturn ehf. (Norðurturn) a limited liability company in liquidation commenced litigation against Eignarhaldsfélag Smáralindar ehf. (Eignarhaldsfélag Smáralindar) a limited liability company owned by Reginn (a subsidiary of the Bank). The main operation of Norðurturn was the construction of an office building in the municipality of Kópavogur next to the shopping mall Smáralind owned by Eignarhaldsfélag Smáralindar. Norðurturn constructed a parking complex adjacent to Smáralind and now it is claimed on Norðurturn's behalf that the construction was done in accordance with an agreement between Norðurturn and Eignarhaldsfélag Smáralindar. Norðurturn's claim amounts to ISK 1,3 billion plus interest. On behalf of Eignarhaldsfélag Smáralindar it is argued that there was no such agreement and will defend its position in court. In the unlikely event that a court will rule in favor of Norðurturn the Bank has guaranteed payment on behalf of Eignarhaldsfélag Smáralindar.

10) In June 2011 Hestafl ehf. (Hestafl) a limited liability company commenced litigation before the District Court of Reykjavík against the Bank. Hestafl's claim amounts to ISK 230 million plus interests from 12 December 2009 on the basis of a demand guarantee issued by the Bank in August 2008. The Bank issued the guarantee in connection with Hestafl's acquisition of the construction company TSH hf., a limited liability company. TSH had rights issued to build an apartment complex in the municipality of Selfoss, however after the collapse of the economy in Iceland in the following months the construction never broke ground. The guarantee's terms for payment were based on the construction reaching certain milestones which were never reached. On those grounds it is the Bank's view that Hestafl's claim lacks merit. The case was heard in the District Court of Reykjavík 7 February 2012.

38. Pledged assets

On 12 October 2010 the Bank and Landsbanki Íslands hf. signed a pledge agreement according to which the Bank pledged certain pools of loans to customers as collateral for the secured bonds issued on 12 October 2010 and the contingent bond the Bank might issue to Landsbanki Íslands hf. The Bank must maintain a minimum cover ratio of 127.5% (ISK 353,272 million) (31.12.2010: ISK 333,174 million) for the secured bonds. However, an amount of ISK 365,449 million has been pledged for the secured bonds as at 31 December 2011 (31.12.2010: ISK 356,290 million). Once the contingent bond has been issued, the Bank must pledge assets for the bond, with a minimum cover ratio of 118%. However, no assets must be pledged for the contingent bond before its issue date. Pledged assets added to the pledged pool must comply with certain eligibility criteria.

In addition, the Bank has pledged assets, in the ordinary course of banking business, to the Central Bank of Iceland in the amount of ISK 5,789 million as at 31 December 2011 (31.12.2010: ISK 5,500 million) to secure settlement in the Icelandic clearing systems. Further pledges have been placed in the ordinary course of banking business for netting and set-off arrangements in the total amount of ISK 12,858 million as at 31 December 2011 (31.12.2010: ISK 7,123 million).

39. Leasing

Operating lease commitments where the Group is lessee

In cases where the Group is a lessee, the future minimum lease payments under non-cancellable operating leases were as follows on 31 December:

	2011	2010
No later than 1 year	47	29
Later than 1 year and no later than 5 years	339	172
Later than 5 years	183	271
Total	**569**	**472**

Operating lease commitments where the Group is legal lessor

The Group acts as the legal lessor whereby tools and equipment are purchased and leased to third parties under arrangements that in substance are loans and advances accounted for under IAS 39 in the consolidated financial statements of the Group.

The future minimum lease payments expected to be received under non-cancellable operating leases were as follows on 31 December:

	2011	2010
Less than 1 year	2,118	3,356
More than 1 year and less than 5 years	3,135	3,570
More than 5 years	278	407
Total	**5,531**	**7,333**

Finance lease commitments where the Group is lessor

The Group acts as lessor whereby items of plant and equipment are leased to third parties under arrangements qualifying as finance leases. Finance lease receivables are included within loans and advances to customers.

The net investment in finance lease receivables was as follows:

At 31 December 2011	Gross investment in finance lease	Future finance income	Present value of minimum lease
Less than 1 year	9,229	(901)	8,328
More than 1 year and less than 5 years	15,961	(1,236)	14,725
More than 5 years	2,086	(162)	1,924
Total	**27,276**	**(2,299)**	**24,977**
At 31 December 2010			
Less than 1 year	7,573	(1,412)	6,161
More than 1 year and less than 5 years	16,870	(2,065)	14,805
More than 5 years	1,306	(41)	1,265
Total	**25,749**	**(3,518)**	**22,231**

Unguaranteed residual value at year end 2011 is nil (2010: nil).

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40. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services. All of them require the Group to make decisions on the handling, acquisition or disposal of financial instruments. Assets in Bank custody are not reported in the consolidated financial statements, since they are not assets of the Bank. One aspect of these services is that the Group is involved in approving objectives and criteria for investing assets in its custody. As of 31 December 2011, financial assets managed by the Group amounted to ISK 112 billion (2010: ISK 100 billion). Custody accounts amounted to ISK 1,093 billion (2010: ISK 998 billion).

41. Related party transactions

Related parties

The Icelandic State Treasury, on behalf of the Icelandic State, holds 81.3% of the shares in the Bank. Government bodies and public institutions qualifying as related parties are the Ministry of Finance, the ISFI (Icelandic State Financial Investments), and entities and institutions related to them.

Transactions between the Bank and its subsidiaries meet the definition of related party transactions. All transactions with subsidiaries are eliminated on consolidation and are thus not disclosed in the Group's consolidated financial statements. The main subsidiaries held directly or indirectly by the Bank at 31 December 2011 were the following:

Company	Ownership interest	Activity
Eignarhaldsfélag Landsbankans ehf. (Ísland)	100%	Eignarhaldsfélag
Horn fjárfestingarfélag hf. (Iceland)	100%	Investment company
Reginn hf. (Iceland)	100%	Real estate company
Landsvaki hf. (Iceland)	100%	Management company for mutual funds
Landsbréf hf. (Iceland)	100%	Management company for mutual funds
Hömlur ehf. (Iceland)	100%	Holding company
Blámi - fjárfestingafélag ehf (Iceland)	100%	Holding company
Vörður líftrygging ehf. (Iceland)	60%	Insurance company
Landsbanki Vatnsafl ehf. (Iceland)	100%	Holding company
Span ehf. (Iceland)	100%	IT-services
Landsbanki Holdings UK plc. (United Kingdom)	100%	Holding company

Landsbanki Íslands hf. has significant influence over the Bank, indirectly through its wholly-owned subsidiary Landsskil ehf., which holds 18.7% of the shares in the Bank. Landsskil ehf. appoints one of the five members of the Board of Directors of the Bank and Landsbanki Íslands hf. has also influence through its observers role in the Bank's Credit committees. Although these observers do not have rights to take part in the decision process during meetings of the Ctredit committees of the Bank they can submit their own comments outside such meetings, which can have an impact on the valuation of the contingent bond. Due to the ownership, its member on the Board of Directors of the Bank and influence through the Credit committees of the Bank, Landsbanki Íslands hf. meets the definition of related party.

The key management personnel of the Bank and its close family members meet the definition of related parties and in some cases the key management personnel of the Bank's subsidiaries. The key management personnel of the Bank are the members of the Board of Directors, CEO, Managing Directors and other directors having authority and responsibility for planning, directing, and controlling the activities of the Bank. The Minister of Finance and the members of the Board of Directors of ISFI meet the definition of key management personnel of the Bank due to their ability to influence the policy of the Bank.

Transactions with related parties

(a) Transactions with the Icelandic government and government-related entities

The Group's products and services are offered to the Icelandic government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner, the Bank and other Group entities purchase products and services from government-related entities at market price and otherwise under generally accepted commercial terms. The nature and outstanding amounts receivable from public entities are disclosed in Note 54.

All amounts are in ISK million

41. Related party transactions (continued)

(b) Transactions with other related parties

The deposits from Landsbanki Íslands hf. amounted to ISK 29,942 million as at 31 December 2011 (31.12.2010: ISK 33,418 million). During the year 2011 the Bank recognised ISK 324 million from administrative services provided to Landsbanki Íslands hf. based on a service level agreement (2010: ISK 479 million).

The following table presents the total amounts of loans to key management personnel and parties related to them and loans to associates of the Group:

	2011		2010	
Loans in ISK million	**Balance at 31 December**	**Highest amounts outstanding during the year**	**Balance at 31 December**	**Highest amounts outstanding during the year**
Key management personnel	112	133	161	200
Parties related to key management personnel	247	299	250	331
Associates*	48,136	84,971	7,273	7,307
Total	**48,495**	**85,403**	**7,684**	**7,838**

*The increse in the year 2011 is due to new associates.

No specific allowance for impairment was recognised in respect of these loans.

No guarantees, pledges or commitments have been given or received in respect of these transactions in the period. There are no leasing transactions between related parties in the period.

(c) Compensation to directors, CEOs and managing directors

Salary and benefits for the year 2011	**Salary and benefits***	**Termi-nation benefits**	**Total**
Gunnar Helgi Hálfdanarson, Chairman of the Board of the Bank	6.4	-	6.4
Sigríður Hrólfsdóttir, Vice-chairman of the Board of the Bank	5.1	-	5.1
Guðríður Ólafsdóttir, member of the Board of the Bank	1.6	-	1.6
Þórdís Ingadóttir, member of the Board of the Bank	4.1	-	4.1
Ólafur Helgi Ólafsson, member of the Board of the Bank	4.1	-	4.1
Andri Geir Arinbjarnarson, member of the Board of the Bank	4.4	-	4.4
Other alternate directors of the board of the Bank	3.5	-	3.5
Steinþór Pálsson, CEO of the Bank	13.9	-	13.9
8 Managing Directors of the Bank's divisions	168.0	-	168.0
Managing Directors of subsidiaries Vestia, Horn, Reginn, Landsvaki and SP fjármögnun	77.3	24.0	101.3
Total	**288.4**	**24.0**	**312.4**

*Benefits are non-monetary benefits in the form of free use of cars owned by the Group.

Contributions made by the Group during the year to defined contribution post-employment benifits plans of directors, CEOs and managing directors amounted to ISK 46 million.

In 2011 the total monthly salary and benefits of the current CEO of the Bank amounted to ISK 1.2 million and the average monthly salary and benefits of current Managing Directors of the Bank's divisions amounted to ISK 1.8 million.

41. Related party transactions (continued)

(c) Compensation to directors, CEOs and managing directors (continued)

Salary and benefits for the year 2010	Salary and benefits	Termi-nation benefits*	Total
Gunnar Helgi Hálfdanarson, Chairman of the Board of the Bank	5.3	-	5.3
Sigríður Hrólfsdóttir, Vice-chairman of the Board of the Bank	3.8	-	3.8
Guðríður Ólafsdóttir, member of the Board of the Bank	3.0	-	3.0
Þórdís Ingadóttir, member of the Board of the Bank	2.6	-	2.6
Ólafur Helgi Ólafsson, member of the Board of the Bank	0.6	-	0.6
Andri Geir Arinbjarnarson, alternate member of the Board of the Bank	2.7	-	2.7
Former members of the Board of the Bank	2.9	-	2.9
Other alternate directors of the board of the Bank	1.1	-	1.1
Ásmundur Stefánsson, former CEO of the Bank	6.0	9.3	15.3
Steinþór Pálsson, CEO of the Bank	7.9	-	7.9
8 Managing Directors of the Bank's divisions	57.8	-	57.8
5 former Managing Directors of the Bank	74.5	70.8	145.3
Managing Directors of subsidiaries Vestia, Horn, Reginn, Landsvaki and SP fjármögnun	56.0	-	56.0
Total	**224.2**	**80.1**	**304.3**

* Employment termination costs payable in the year 2011 were fully recognised as an expense in the year 2010.

In 2010 the total monthly salary and benefits of the current CEO of the Bank amounted to ISK 1.1 million and the average monthly salary and benefits of current Managing Directors of the Bank's divisions amounted to ISK 1.5 million. The average total monthly salary and benefits of the former CEO of the Bank amounted to ISK 1.3 million and the average monthly salary and benefits of former Managing Directors of the Bank's divisions amounted to ISK 1.5 million.

In 2010 the Bank acquired two vehicles as part of the employment terms of two present Managing Directors of the Bank. The acquisition price of both vehicles amounted to ISK 7 million, which was equal to their market value at acquisition date. The vehicles have not been sold at year-end 2011.

(d) Transactions with the Minister of Finance and members of the Board of Directors of the ISFI

The Minister of Finance and the members of the Board of Directors of the ISFI did not receive any salaries or similar payments from the Group during the year 2011. The Group did not enter into any transactions with these persons or close members of their families, other than lending and deposit taking during the normal course of commercial banking operations, with the exception of the following transaction with Sigurður B. Stefánsson, a member of the Board of Directors of the ISFI.

On 9 March 2011 Eignarhaldsfélag Landsbankans ehf., a subsidiary of the Bank, completed the acquisition of all shares in the company Rose Invest hf., half of which were owned by Sigurður B. Stefánsson, a member of the board of the ISFI. Sigurður B. Stefánsson did not participate in any board duties of ISFI after the negotiation with the Bank started and resigned from the board in February 2011. Rose Invest hf. is licensed by the Icelandic Financial Supervisory Authority in Iceland (FME) to manage UCITS and other funds for collective investment and investment advice. The acquisition will reinforce the Bank's position further in the area of asset and fund management as the founders of Rose Invest hf., including Sigurður B. Stefánsson, have joined the Bank´s Asset Management Division. The acquisition price for the shares paid by Eignarhaldsfélag Landsbankans ehf. to Sigurður B. Stefánsson amounted to ISK 23.7 million.

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42. Events after the reporting period

The main events after the reporting period are as follows:

On 15 February 2012 the Court ruled that a lender could not apply the Central Bank interest rates under circumstances specified in the ruling, inter alia, as the lender had issued final receipt of payment of interests. The case did not involve any Group entity but may be of relevance for the Bank. The precedent set by this new ruling is not entirely clear when these consolidated financial statements are authorised for issue. (See Note 4 (h)).

On 9 February 2012 the District Court of Reykjavík ruled in a dispute between the Bank and the Winding-up Board of Landsbanki Íslands hf. regarding classification of a claim of ISK 7.1 billion by the Bank on the bankrupt estate of Landsbanki Íslands hf. Prior to the court proceedings the Winding-up Board had rejected acknowledging the claim as a proprietary claim and filed it as a general claim. The basis of the claim is that on 25 October 2008 excessive funds of ISK 7.1 billion were transferred by the Bank to Landsbanki Íslands hf. Resolution Committee as a settlement between Landsvaki and Landsbanki Íslands hf. The District Court concluded in its ruling that the classification of the claim falls within the scope of paragraph 1 of article 109 in Chapter XVII of Act No. 21/1991, the Law on Bankruptcy. Pursuant to this section of the law the claim classifies as a proprietary claim. The Winding-up Board has appealed the ruling of the District Court to the Supreme Court of Iceland. The carrying amount of the claim is ISK 3.7 billion and if the Supreme Court confirms the verdict of the District Court, the Bank will recognise a gain of ISK 3.4 billion in the consolidated income statement in the year 2012 (See Note 16).

On 6 January 2012 the Board of Directors of Sparisjóður Svarfdæla and Landsbankinn hf. reached an agreement whereby Landsbankinn purchases all assets and operations of the savings bank. According to the terms of the agreement, Landsbankinn takes over the savings bank´s deposit obligations and a subordinated loan in the total amount of ISK 3.2 billion and pays the purchase price of ISK 165 million. Furthermore, Landsbankinn assumes all operational obligations of the savings bank. The sale was approved at the guarantee capital owners meeting of the savings bank on January 24 2012. The purchase offer is conditional upon further approval by the Financial Supervisory Authority in Iceland (FME), the EFTA Surveillance Authority and the Icelandic Competition Authority.

Capital management

43. Capital management

The Group's capital management policies and practices ensure that the Group has sufficient capital to cover the risk associated with its activities.

The capital management framework of the Group comprises 4 interdependent activities: Capital Assessment, Risk Appetite/Capital Target, Capital Planning, and Reporting/Monitoring.

Capital requirements are defined by two external bodies. In addition the Group assesses its own internal capital requirement. The Basel CAD requirement is by standard 8% whereas the Icelandic FME sets local requirement of 16% or 8% additional to the Basel requirement. Internally the bank uses Economic Capital methodology based on Internal Capital Adequacy Assessment Process (ICAAP) for stress testing and to evaluate its minimum CAD requirements under various scenarios.

The Group regularly monitors and assesses its current risk profile in the most important business areas and for the most important risk types. Risk appetite sets out the level of risk the Group is willing to take in pursuit of its business objectives.

The capital planning process is based on the Group's business plan, financial plan and stress testing. The business plan and financial plan project the development of the capital requirements and the available capital, whereas stress tests in the ICAAP project the Group's solvency need and actual capital in various scenarios. Reporting and monitoring of the capital requirement of the Group is mainly in the form of quarterly management reports and the ICAAP report.

The Financial Supervisory Authority in Iceland (FME) has decided that the Group is to maintain a Tier 1 capital ratio of at least 12% which must be maintained for at least 3 years after the initial capitalisation unless revised by FME. Furthermore, the Group must maintain a capital adequacy ratio (CAD ratio) above 16% unless FME approves a lower CAD ratio on the basis of additional capital resources available for the Group. This is higher than the current ICAAP capital requirement estimated by the Bank.

44. Capital base and capital adequacy ratio

The Group's equity at 31 December 2011 amounted to ISK 200,244 million (2010: ISK 184,866 million), equivalent to 17.6% (2010: 17.1%) of total assets, according to the consolidated statement of financial position. The capital adequacy ratio, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 21.4% at 31 December 2011 (2010: 19.5%). According to the Act, this ratio may not fall below 8%.

Capital base	**2011**	**2010**
Share capital	24,000	24,000
Share premium	123,898	123,898
Statutory reserve	3,781	2,932
Retained earnings	47,952	31,828
Non-controlling interests	613	2,208
Total equity	**200,244**	**184,866**
Intangible assets	(681)	(878)
Deferred tax assets	(3,003)	(1,522)
Tier 1 capital	**196,560**	**182,466**
Deduction from original and additional own funds	(4,531)	(3,888)
Capital base	**192,029**	**178,578**

Risk-weighted assets		
Credit risk	696,402	699,716
Market risk	120,557	144,745
Operational risk	81,500	69,987
Total risk-weighted assets	**898,459**	**914,448**

Tier 1 capital ratio	21.9%	20.0%
Capital adequacy ratio	21.4%	19.5%

All amounts are in ISK million

Risk management

45. Material financial risks

The Group is exposed to the following material risks which arise from financial instruments:
• Credit risk
• Liquidity risk
• Market risk
  - Currency risk
  - Interest rate risk
  - Other market risk

The Group also manages other relevant risk, such as business, operational, legal and compliance risks.

The above material risks are addressed in the following notes.

46. Risk management process

The Group‘s risk appetite has been revised and new measures are being implemented to support it. The statement of the Group‘s risk appetite is as follows:

It is the policy of The Group to take only on risks that the group is able to understand, measure and manage. The Banks strategy and long term vision is to attain the same credit rating as comparable leading banks in the Nordic countries.

The Bank seeks to maintain solid business relationships and avoids taking part in transactions that might damage the Bank's reputation. It will take advantage of market opportunities to ensure diversified and sound financing.
Transactions entered into by the Group aim to limit fluctuations in its operations and ensure that the Group is always in a position to withstand shocks. Moreover, transactions shall take into account the current standing of both the Bank and its customers with due regard for any internal connections. The profitability of the Group should be assessed with respect to risk taken by the bank. The Bank's corporate culture is characterised by professionalism and processes that support its risk strategy.
Executives and employees are responsible for monitoring and managing risks taken on within their units in accordance with the banks rules and local law. Decisions are based on a thorough and professional discussion with the Group's long-term interests in mind. Regular and thorough follow-up on decisions and risk monitoring are integral part of the Group’s operations.

Risk policy is implemented through goal-setting, business strategy, internal rules and limits that comply with the regulatory framework of the financial markets.

Risk is inherent in the Group’s activities and is managed through a process of ongoing identification, measurement, management and monitoring, subject to risk limits and other controls. Risk identification involves finding the origins and structures of possible risk factors in the Group's operations and undertakings. Risk measurement entails measuring the identified risks for management and monitoring purposes. Finally, risk controls and limits ensures compliance with rules and procedures as well as to ensure compliance with the Group’s risk appetite.

The objective of the Group’s risk policies and procedures is to ensure that the risks in its operations are known, measured, monitored and effectively managed. Exposure to risks is managed to ensure that it will remain within limits as well as risk appetite adopted by the Group and will comply with regulatory requirements. In order to ensure that the fluctuations which might affect the Group’s equity as well as performance are kept limited and manageable the Group has adopted several policies regarding the risk structure of its portfolio which are covered in more detail under each risk type.

47. Risk management framework

The Group's risk management governance structure as at year-end 2011 is as follows:

Supervision by the Board of Directors	**Board of Directors** Internal Audit, Remuneration Committee, Audit and Risk Committee, Governance Committee				
Key management bodies and committees	**The CEO** Risk and Finance Committee Credit Committee Executive Management Committee				
Risk types	Compliance risk	Credit risk	Market risk	Operational risk	Liquidity risk

The Board of Directors of the Bank has overall responsibility for the establishment and oversight of the Group's risk management framework and risk appetite setting. The CEO is responsible for the effective implementation through the corporate governance structure and committees. The CEO has established the Risk and Finance Committee, the Credit Committee and the Executive Management Committee, which are responsible for developing and monitoring Group risk management policies in their specified areas.

The Bank's CEO is a member of three committees, each of which handles different aspects of risk: the Risk and Finance Committee, the Credit Committee and the Executive Management Committee. The Credit Committee deals with credit risk, while the Risk and Finance Committee covers primarily market risk and liquidity risk. The Risk and Finance Committee monitors all the Group's risks and is responsible for enforcing the Bank's risk appetite and risk limits, and reviews and approves changes to risk models before presented to the Board of Directors. Moreover, the CEO is a member of the Executive Management Committee, which serves as a forum for consultation and communication between the CEO and managing directors, addressing the main current issues in each division. This committee makes all major decisions which are not being consulted on elsewhere or being considered in other standing committees.

The Bank's Risk Managment Division is responsible for the Group's risk management framework. Subsidiaries of the Bank have their own risk management functions, but the Risk Management Division receives information on exposures from the subsidiaries and collates them into Group exposures.

The Compliance Department ensures that the Group adheres to its rules on securities trading and insider trading and operations comply with the Act on Securities Transactions, the Act on Actions to Combat Money Laundering and Terrorist Financing, and other relevant legislation and regulations. This department also concentrates on Group adherence to codes of ethics and on limiting market abuse, minimising conflicts of interest and ensuring best practice. Such compliance is one of the Group's support functions and is integral to its corporate culture.

Internal Audit is part of the Group's risk management framework as well as being a part of the surveillance system. The purpose of Internal Audit in the risk management process is to confirm that risk management is functioning and is sufficient for the Group. The effectiveness of the Group's risk management and risk assessment procedures, including the ICAAP process, is evaluated by Internal Audit and the findings are reported to the Board of Directors. Internal audit activities extend to every operating unit, including the Bank's subsidiaries.

48. Risk management

The Risk Management division has six units.

• The Credit Management Unit is responsible for risk assessment and secondary voting on credit applications for customers with exposures exceeding the credit limits of individual business units and customers which have been classified yellow, orange or red (see Note 52). Secondary voting on decisions exceeding the limits of the Risk Management Division is referred to the Bank's Credit Committee.

• The Credit Risk Monitoring Unit is responsible for monitoring the Bank's credit portfolio. This is done by operating an early warning system which classifies customers and transfers them between the categories standard/watchlist and restructuring. The unit also works with other units on large exposure and impairment analysis.

• Asset and Liability Management Risk (ALM Risk) is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the banking book for the Group. ALM Risk is also responsible for monitoring all derivatives trading the Group enters into, both for hedging and trading purposes.

• The Operational Risk Unit is responsible for ensuring that Group operational risks are captured and that the Group implements, maintains and monitors an effective operational risk management framework.

• Models and Analysis Unit's role is to provide, develop and maintain the Bank's internal models and related processes to measure risk, including the Economic Capital framework; as well as to support the implementation of such models and processes within the Bank. In addition the unit is responsible for credit risk reporting to regulators and within the Bank.

• The Economic Research Unit is responsible for the analysis of the external domestic and international economic environment relevant to the Bank's operations. The analysis provides support to management in planning, risk management and decision-making. The main task of the department within the risk management context is to design and analyse macroeconomic scenarios which are applied in the stress testing process.

Credit risk

49. Credit risk

Credit risk is defined as the risk of loss if counterparts fail to fulfil their obligations and that the pledged collaterals do not cover the existing claims.

Credit risk is the greatest single risk faced by the Group and arises principally from loans and advances to customers and from investments in debt securities, but also from commitments, guarantees and documentary credits, counterparty credit risk in derivatives contracts, and settlement risk.

Due to the effects of the financial crisis, there is rather high uncertainty concerning the recovery of the loan portfolio. This uncertainty is reflected by traditional measures of credit risk.

50. Credit risk management

The Group's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk and Finance Committee, the Credit Committee and the credit units within the Risk Management. The Group manages credit risk according to its risk appetite statement and credit policy approved by the Board of Directors as well as detailed lending rules approved by the CEO. The risk appetite statement and credit policy include exposure limits on large exposures to individual borrowers or groups of borrowers, concentration of risk and exposures to certain industries. The CEO ensures that the risk policy is reflected in the Group's internal framework of regulation and guidelines. The CEO monitors together with the Bank's managers that the Bank's business units execute the risk policy appropriately.

Incremental credit authorization levels are defined based on size of units, types of customers and lending experience of credit officers. Credit decisions exceeding authorization levels of business units are subject to approval by Credit management within the Risk Management. Credit decisions exceeding the limits of Credit management are subject to approval by the Bank's Credit Committee. Credit decisions exceeding the limits of the Credit Committee are subject to approval by the Credit Committee of the Board of Directors which has the highest credit authorization within the Bank.

51. Credit risk mitigation

Non-derivative financial instruments

Credit risk mitigation is an inherent part of the credit decision process and securing loans with collateral is the main method of mitigating credit risk.

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Guidelines are clarified by the Group regarding valuation parameters and the acceptability of different types of collateral. Credit extended by the Group may be secured on residential or commercial properties, land, securities, transport vessels, fishing vessels together with their non-transferable fishing quotas, aircraft, etc. The Group also secures its loans by means of receivables and operating assets, such as machinery and equipment. Residential mortgages involve the underlying residential property. Less stringent requirements are set for securing short-term personal loans, such as overdrafts and credit card borrowings.

Where possible, the Group monitors the market value of collateral and may require additional collateral in accordance with the underlying loan agreement.

The current discussion and political debate on possible changes to the fishing quota system in Iceland, which may include a gradual decrease in the quota awarded to current quota owners, may have an adverse effect on the value of the fishing vessels placed as security for part of the corporate loan portfolio of the Bank. This could therefore have an adverse effect on the value of the Bank‘s loan book. At the moment, it is impossible to determine precisely any such effect, as the matter is still being discussed by the Government and the first bill has been withdrawn and is currently being reviewed.

The Group is implementing a new collateral system, which is developed internally and allows the Group to analyse the quality and value of the collateral held to secure the loan portfolio.

In order to limit further the credit risk arising from financial instruments, the Group enters into netting agreements, under which in cases of default the Group is able to set off all contracts covered by the netting agreement against the debt. The arrangements generally include all market transactions between the Group and the client.

Generally, collateral is not held over loans and advances to financial institutions, nor is it usually held against bonds and debt instruments.

Derivative financial instruments

In order to mitigate credit risk arising from derivatives the Group chooses the counterparties for derivatives trading based on stringent rules, according to which clients must qualify as professional clients but only if certain conditions are met. The Group also enters into standard ISDA master netting agreements with foreign counterparties and similar general netting agreements with domestic counterparties.

In addition, the Group has in place margin procedures for derivatives. The clients are required to hold a margin account with the Group where the collateral (i.e. cash or government bonds with rating at least BBB) is in custody and under management. The client pledges the value of the margin account to the Group, thus reducing the risk of the Group should the client default. The margin system also defines that a client‘s collateral must be at least equal to the credit equivalent value of the derivative, which is the current potential cost of replacing the contract‘s expected net cash flows should the counterparty default.

The Group issues a margin call if a client‘s collateral balance falls below the maintenance margin, which is defined as a percentage of the notional amount of the derivative and varies by type of derivative. In a margin call the Group demands that the client must bring additional collateral, usually within two days, in order to cover the losses. Otherwise the Group closes all or several contracts and takes possession of the collateral so that the collateral balance covers the credit equivalent value again.

The Group‘s supervision system monitors derivatives exposure and collateral value intraday, it issues margin calls and manages netting agreements.

52. Credit risk measurement

The Group monitors exposures to identify signs of weakness in customer earnings and liquidity as soon as possible. On the basis of customer data, the Group has developed internally a number of statistical models to predict the probability of customers defaulting on their obligations to the Group, as defined in the internal rating based approach of the Basel II framework. Customers of the Group are assigned to a rating grade on the internal rating scale on the basis of the estimated probability of default. During 2011 a new rating scale was implemented as well as an improved internal rating model for corporate customers. The work to improve the Group's internal rating system which started in 2010 will continue in 2012, with the objective to ensure compliance with the internal rating based approaches, starting with the foundation approach.

Supplemental to using ratings, the Group uses a second classification of four credit risk groups (green, yellow, orange and red). The classification were originally used for customer groups with loan exposures above ISK 500 million from the foundation of the Bank in 2008 until 2010. Following changes in the structure of the Risk Management in 2010 and the implementation of a credit risk early warning system, the colour classification used in 2011 was the following:

• Green customers are those that are considered performing without difficulties.

• Yellow customers are those that are on Watch list 1, which have temporary difficulties and may need some installments postponed or modification to terms or loan covenants.

• Orange customers are those that are on Watch list 2. They are still under the supervision of the relevant business unit but are likely to go through debt restucturing or installments postponed.

• Red customers are those that are under the supervision of the Asset Restructuring division and need restructuring, write-offs or debt-to-equity conversion. The management of the customer's operations will possibly be taken over by the Group. In some cases, collateral or guarantees will be collected and/or the operations sold.

The Credit Risk Monitoring unit within Risk Management is responsible for the verification of colour for the customer and transfer of customers from the business units to Asset Restructuring.

The following table presents the classification of loans and advances to customers by credit risk groups:

Carrying amount	2011	2010
Green	376,323	354,420
Yellow	66,907	62,684
Orange	53,637	68,875
Red	142,263	106,975
Total	**639,130**	**592,954**

External ratings were used where applicable to assist in managing the credit risk exposure of bonds. Otherwise the Group used fair value estimates based on available information and the Group's own estimates.

The Group measures the credit risk of derivatives by calculating a credit equivalent value for each derivative. The credit equivalent value is the market value of a contract plus a percentage of the nominal amount of the derivative which depends on the type of derivative. The percentage is twice that of the 99% Value at Risk (VaR), calculated for each underlying security or currency based on historical volatility, for a holding period of five days.

All amounts are in ISK million

53. Loan impairment

Group policy requires that individual financial assets above materiality thresholds be reviewed at least quarterly, and more frequently when circumstances so demand. Impairment allowances on individually assessed accounts are determined case-by-case by evaluating incurred losses at the reporting date. Collectively assessed impairment allowances are permitted in the following cases: (i) portfolios of homogenous loans that are individually below materiality thresholds, and (ii) losses that have been incurred but not yet identified, using the available historical experience together with experienced judgement and statistical techniques.

Should the expected cash flows be re-examined and the present value of the cash flows (calculated using the effective interest rate) be revised, the difference is then recognised in profit or loss (as either impairment or net adjustments to loans and advances). Impairment is calculated using the effective interest rate, before any revision of the expected cash flows. Any adjustments to the carrying amount which result from revising the expected cash flows are recognised in profit or loss. The impact of financial restructuring of the Group's customers in 2011 is reflected in loan impairment, or net adjustments to loans and advances, as the expected cash flow of customers has changed.

The Group measures and estimates the impact of foreign exchange rate changes on the financial strength of each borrower or group of borrowers. While some customers receive income partially or fully in foreign currency, other customers have very limited or no income in foreign currency. Customers with limited income in foreign currency are more likely to get into financial difficulties than others, should the ISK depreciate. Hence, the Group has stopped issuing loans in foreign currency unless the customer's income is in the same currency. Moreover, existing loans in foreign currency have been reissued in ISK if the customer's income is also in ISK.

54. Maximum exposure to credit risk and concentration by industry sectors

The following tables represent the Group's maximum credit risk exposure at 31 December 2011 and 2010. For on-balance sheet assets, the exposures set out below are based on net carrying amounts as reported in the statement of financial position. Off-balance sheet amounts in the tables below are the maximum amounts the Group might have to pay for guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities. The loans to individuals are residential mortgages and consumer lending. Consumer lending consists of current account loans, ISK term loans and loans dominated in foreign currencies, to name a few of the lending forms.

Mitigating risks in the credit portfolio is a key element of the Group's credit policy. For many loan products, collateral is required by legislation, as in the mortgage finance market, or is standard market practice.

Important means of risk mitigation are collaterals and guarantees. The most important types of collaterals are real property and financial assets (shares or bonds).

The Group regularly assesses the market value of collateral received. The Group has developed models to estimate the value of the most frequent types of collateral. For collateral for which no valuation model exists, the Group calculates the value manually. It calculates the value as the market value less a haircut. The haircut represents a conservative estimate of the costs to sell in a forced sale. Costs to sell include maintenance costs in the period over which the asset is up for sale, fees for external advisory services and any loss in value. For real property, haircuts depend on the property type, condition, location and other criteria and usually range between 30% and 50% of the property's market value. For listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability. The haircut is 70% for unlisted securities.

54. Maximum exposure to credit risk and concentration by industry sectors (continued)

The Group uses the ISAT 08 industry classification for corporate customers. This classification is based on the NACE Rev. 2 industry classification used by EEA countries.

				Corporations									
At 31 December 2011	Financial institutions	Public entities*	Individuals	Fisheries	Construction and real estate companies	Services	Retail	Holding companies	Manufacturing	Agriculture	ITC**	Other	Carrying amount
Cash and balances with Central Bank	-	8,823	-	-	-	-	-	-	-	-	-	-	**8,823**
Bonds and debt instruments	10,118	208,802	-	-	2	-	-	2,249	306	-	-	371	**221,848**
Derivative instruments	100	-	-	43	-	-	-	-	-	-	-	16	**159**
Loans and advances to financial institutions	100,133	-	-	-	-	-	-	-	-	-	-	-	**100,133**
Loans and advances to customers	-	12,139	173,223	135,397	101,958	66,121	42,401	48,622	28,008	8,505	20,168	2,588	**639,130**
Other financial assets	3,089	42	-	11	-	562	-	600	2	-	4	11	**4,321**
Total on-balance sheet exposure	**113,440**	**229,806**	**173,223**	**135,451**	**101,960**	**66,683**	**42,401**	**51,471**	**28,316**	**8,505**	**20,172**	**2,986**	**974,414**
Off-balance sheet exposure	**0**	**7,583**	**31,658**	**11,272**	**8,192**	**8,586**	**11,348**	**6,466**	**2,876**	**2,150**	**2,626**	**1,156**	**93,913**
Financial guarantees	-	28	512	1,232	3,949	2,529	1,723	275	690	170	1,195	32	12,335
Undrawn loan commitments	-	4,130	22	7,875	2,380	254	4,851	5,507	369	1,655	371	327	27,741
Undrawn overdraft/credit card facilities	-	3,425	31,124	2,165	1,863	5,803	4,774	684	1,817	325	1,060	797	53,837
Maximum exposure to credit risk	**113,440**	**237,389**	**204,881**	**146,723**	**110,152**	**75,269**	**53,749**	**57,937**	**31,192**	**10,655**	**22,798**	**4,142**	**1,068,327**
Percentage of carrying amount	10.6%	22.2%	19.2%	13.7%	10.3%	7.1%	5.0%	5.5%	2.9%	1.0%	2.1%	0.4%	100.0%

* Public entities consist of central government, state-owned enterprises, Central Bank and municipalities.

** ITC consists of corporations in the information, technology and communication industry sectors.

All amounts are in ISK million

54. Maximum exposure to credit risk and concentration by industry sectors (continued)

				Corporations									
At 31 December 2010	Financial institutions	Public entities*	Individuals	Fisheries	Construction and real estate companies	Services	Retail	Holding companies	Manufacturing	Agriculture	ITC**	Other	Carrying amount
Cash and balances with Central Bank	-	47,777	-	-	-	-	-	-	-	-	-	-	**47,777**
Bonds and debt instruments	10,744	147,036	-	-	2	-	-	3,776	-	-	-	1	**161,559**
Derivative instruments	20	-	-	-	-	-	-	3	-	-	-	-	**23**
Loans and advances to financial institutions	91,882	-	-	-	-	-	-	-	-	-	-	-	**91,882**
Loans and advances to customers	-	13,591	163,203	134,037	100,038	66,752	33,582	37,243	22,872	11,666	6,597	3,373	**592,954**
Other financial assets	6,316	42	-	12	-	433	1	19	10	-	154	83	**7,070**
Total on-balance sheet exposure	**108,962**	**208,446**	**163,203**	**134,049**	**100,040**	**67,185**	**33,583**	**41,041**	**22,882**	**11,666**	**6,751**	**3,457**	**901,265**
Off-balance sheet exposure	**0**	**7,232**	**33,184**	**11,904**	**5,801**	**9,672**	**12,053**	**2,184**	**3,090**	**2,479**	**2,483**	**289**	**90,371**
Financial guarantees	-	12	478	884	3,240	2,325	1,222	228	618	340	855	31	10,233
Undrawn loan commitments	-	2,564	49	8,781	876	3,335	6,452	846	891	1,636	675	-	26,105
Debt underwriting commitments	-	1,090	-	-	-	-	-	-	-	-	-	-	1,090
Undrawn overdraft/credit card facilities	-	3,566	32,657	2,239	1,685	4,012	4,379	1,110	1,581	503	953	258	52,943
Maximum exposure to credit risk	**108,962**	**215,678**	**196,387**	**145,953**	**105,841**	**76,857**	**45,636**	**43,225**	**25,972**	**14,145**	**9,234**	**3,746**	**991,636**
Percentage of carrying amount	11.0%	21.7%	19.8%	14.7%	10.7%	7.8%	4.6%	4.4%	2.6%	1.4%	0.9%	0.4%	100.0%

* Public entities consist of central government, state-owned enterprises, Central Bank and municipalities.

** ITC consists of corporations in the information, technology and communication industry sectors.

All amounts are in ISK million

55. Loans and advances by industry sectors

Industry sectors	2011 Gross carrying amount	2011 Allowance for impairment	2011 Carrying amount	2010 Gross carrying amount	2010 Allowance for impairment	2010 Carrying amount
Financial institutions	100,133	-	100,133	94,060	(2,178)	91,882
Public entities	12,143	(4)	12,139	13,928	(337)	13,591
Individuals	186,033	(12,810)	173,223	166,069	(2,866)	163,203
Corporations						
Fisheries	137,878	(2,481)	135,397	136,985	(2,948)	134,037
Construction and real estate companies	107,013	(5,055)	101,958	104,092	(4,054)	100,038
Holding companies	51,112	(2,490)	48,622	41,937	(4,694)	37,243
Retail	44,443	(2,042)	42,401	35,248	(1,666)	33,582
Services	68,301	(2,180)	66,121	69,721	(2,969)	66,752
Information, technology and communication	20,261	(93)	20,168	6,780	(183)	6,597
Manufacturing	28,708	(700)	28,008	23,865	(993)	22,872
Agriculture	8,834	(329)	8,505	11,909	(243)	11,666
Other	2,824	(236)	2,588	3,542	(169)	3,373
Total	**767,683**	**(28,420)**	**739,263**	**708,136**	**(23,300)**	**684,836**

56. Credit quality of financial assets

	Gross carrying amount					
At 31 December 2011	**Neither past due nor individually impaired**	**Past due but not individually impaired**	**Individually impaired**	**Total**	**Allowance for impairment**	**Carrying amount**
Cash and balances with Central Bank	8,823	-	-	8,823	-	8,823
Bonds and debt instruments	212,930	8,918	-	221,848	-	221,848
Derivative instruments	159	-	-	159	-	159
Loans and advances to financial institutions	99,972	161	-	100,133	-	100,133
Loans and advances to customers	439,699	117,264	110,587	667,550	(28,420)	639,130
Other financial assets	4,321	-	-	4,321	-	4,321
Total	**765,904**	**126,343**	**110,587**	**1,002,834**	**(28,420)**	**974,414**
At 31 December 2010						
Cash and balances with Central Bank	47,777	-	-	47,777	-	47,777
Bonds and debt instruments	152,216	9,343	-	161,559	-	161,559
Derivative instruments	23	-	-	23	-	23
Loans and advances to financial institutions	71,929	196	21,935	94,060	(2,178)	91,882
Loans and advances to customers	444,530	169,380	166	614,076	(21,122)	592,954
Other financial assets	7,070	-	-	7,070	-	7,070
Total	**723,545**	**178,919**	**22,101**	**924,565**	**(23,300)**	**901,265**

The allowance for impairment includes both the allowance for individual impairment and the allowance for collective impairment.

All amounts are in ISK million

57. Loans and advances neither past due nor individually impaired

	Credit risk groups					
At 31 December 2011	**Green**	**Yellow**	**Orange**	**Red**	**Gross carrying amount**	**PD**
Financial institutions	99,972	-	-	-	99,972	-
Public entities	8,342	39	57	3	8,441	2.71%
Individuals	90,741	2,247	7,304	3,583	103,875	1.54%
Corporations						
Fisheries	78,560	10,644	405	7,929	97,538	10.57%
Construction and real estate companies	40,032	10,004	9,152	11,399	70,587	14.82%
Holding companies	8,702	6,692	475	16,249	32,118	11.08%
Retail	12,223	6,398	513	8,756	27,890	12.13%
Services	39,300	1,735	9,839	2,553	53,427	6.30%
Information, technology and communication	20,789	68	45	59	20,961	2.03%
Manufacturing	16,946	2,273	477	1,383	21,079	9.57%
Agriculture	1,591	271	34	401	2,297	7.09%
Other	1,117	336	31	2	1,486	5.37%
Total	**418,315**	**40,707**	**28,332**	**52,317**	**539,671**	**8.42%**
At 31 December 2010						
Financial institutions	71,929	-	-	-	71,929	-
Public entities	8,583	1,495	964	1,436	12,478	4.71%
Individuals	86,108	11,110	4,647	18,298	120,163	1.99%
Corporations						
Fisheries	83,459	2,738	5,623	22,700	114,520	9.67%
Construction and real estate companies	10,351	3,412	12,117	29,851	55,731	22.99%
Holding companies	8,530	1,698	2,001	12,150	24,379	14.47%
Retail	16,539	2,707	3,621	4,407	27,274	17.83%
Services	37,496	1,133	3,930	12,507	55,066	16.01%
Information, technology and communication	5,498	358	32	519	6,407	6.12%
Manufacturing	5,971	3,111	380	6,185	15,647	31.39%
Agriculture	4,132	2,632	19	3,387	10,170	16.59%
Other	2,680	-	-	15	2,695	7.51%
Total	**341,276**	**30,394**	**33,334**	**111,455**	**516,459**	**11.89%**

58. Loans and advances past due but not individually impaired

The following table shows the gross carrying amount of loans and advances to financial institutions and customers that have failed to make payments which had become contractually due by one or more days.

At 31 December 2011	**Past due up to 30 days**	**Past due 31 - 60 days**	**Past due 61 - 90 days**	**Past due over 90 days**	**Gross carrying amount**
Loans and advances to financial institutions	1	7	9	144	161
Loans and advances to customers	23,014	11,826	7,640	74,784	117,264
Total	**23,015**	**11,833**	**7,649**	**74,928**	**117,425**
At 31 December 2010					
Loans and advances to financial institutions	5	-	1	190	196
Loans and advances to customers	15,578	10,918	3,476	139,408	169,380
Total	**15,583**	**10,918**	**3,477**	**139,598**	**169,576**

All amounts are in ISK million

59. Individually impaired loans and advances to financial institutions and customers

At 31 December 2011	Gross carrying amount	Allowance for impairment	Carrying amount
Loans and advances to customers	110,587	(19,696)	90,891
At 31 December 2010			
Loans and advances to financial institutions	21,935	(2,178)	19,757
Loans and advances to customers	166	(64)	102
Total	**22,101**	**(2,242)**	**19,859**

60. Allowance for impairment on loans and advances to financial institutions and customers

	1.1-31.12.2011			1.1-31.12.2010		
	Financial institutions	Customers	Total	Financial institutions	Customers	Total
Balance at the beginning of the year	2,178	21,122	23,300	727	7,760	8,487
Impairment loss for the period	(2,178)	9,310	7,132	1,451	13,362	14,813
Loans written-off	-	(2,012)	(2,012)	-	-	-
Balance at the end of the period	**0**	**28,420**	**28,420**	**2,178**	**21,122**	**23,300**
Individual allowance	-	19,696	19,696	2,178	64	2,242
Collective allowance	-	8,724	8,724	-	21,058	21,058
Total	**0**	**28,420**	**28,420**	**2,178**	**21,122**	**23,300**
Net impairment loss on loans and advances						
Impairment loss for the period	(2,178)	9,310	7,132	1,451	13,362	14,813
Collected previously written-off loans	-	(98)	(98)	-	(177)	(177)
Total	**(2,178)**	**9,212**	**7,034**	**1,451**	**13,185**	**14,636**

61. Renegotiated loans

Financial restructuring and renegotiation of loans to the Group's customers acquired from Landsbanki Íslands hf. started in 2009. In regard to financial restructuring of customers, the Group has put remedies in place for those experiencing financial difficulties and also presented procedures for financial restructuring. These restructuring approaches include extended and modified repayment arrangements and approved external management plans. During the year 2011 the Bank continued its focus and effort in restructuring loans to individuals and companies.

The restructuring of the loans acquired from Landsbanki Íslands hf. gives rise to uncertainties about the net expected future cash flows from the loans due to various reasons, including legal and tax implications.

All amounts are in ISK million

62. Large exposures

At 31 December 2011, two Group clients were rated as large exposures (31 December 2010: two clients), including subsidiaries of the Group classified as held for sale. Clients are rated as large exposures if their total obligations, or those of financially or administratively connected parties, exceed 10% of the Group's capital base. The large exposures amount is calculated after taking account of collateral held, in accordance with the Financial Supervisory Authority's Rules on Large Exposures Incurred by Financial Undertakings No. 216/2007. According to these rules, no exposure may attain the equivalent of 25% of the capital base. All of the Group's large exposures were within these limits as at 31 December 2011 and 2010.

At 31 December 2011, the Group's internal rules on large exposures stated that clients could comprise up to 20% of the Group's capital base. However the Bank's Board of Directors can permit a large exposure to comprise up to 25% of the Group's equity when the purpose of the exposure is to protect the interests of the Bank. At 31 December 2011, one exposure exceeded 20% (31 December 2010: one exposure). According to the Group's risk appetite, the total utilisation percentage of a large exposure ought to remain below 50% of the Group's capital base.

At 31 December 2011	Number of large exposures	Large exposures
Large exposures above 20% of the Group's capital base	1	47,989
Large exposures between 10% and 20% of the Group's capital base	1	33,131
Total	**2**	**81,120**
Utilisation of 400%* limit		42%
At 31 December 2010		
Large exposures above 20% of the Group's capital base	1	36,279
Large exposures between 10% and 20% of the Group's capital base	1	19,375
Total	**2**	**55,654**
Utilisation of 800%* limit		31%

* Change in article 30 in the law of financial undertakings no. 161/2002

63. Bonds and debt instruments

A breakdown of the Group's bond portfolio, by Moody's rating, is as follows:

Carrying amount	2011	2010
Aaa	61,752	8,989
Aa3	38	-
A1 to A3	-	646
Baa1 to Baa3	144,791	136,338
Lower than Baa3	959	9,186
Unrated	14,308	6,400
Total	**221,848**	**161,559**

Unrated bonds and bonds with ratings lower than Baa3 are primarily bonds issued by domestic corporations, some of which developed into liquidating estates.

The following table shows the carrying amounts of bonds for which the issuers have failed, by one or more days, to make a payment when it was contractually due:

At 31 December 2011	Past due up to 30 days	Past due 31 - 60 days	Past due 61 - 90 days	Past due over 90 days	Carrying amount
Financial institutions	-	-	-	8,434	8,434
Holding companies	-	-	-	484	484
Total	**0**	**0**	**0**	**8,918**	**8,918**
At 31 December 2010					
Financial institutions	-	-	-	8,843	8,843
Holding companies	-	-	-	500	500
Total	**0**	**0**	**0**	**9,343**	**9,343**

All amounts are in ISK million

64. Derivative instruments

The following table sumarises the Group's derivative instruments, classified by the Bank into equivalent Moody's ratings:

	2011			2010		
	Notional	Fair value		Notional	Fair value	
	amount	Assets	Liabilities	amount	Assets	Liabilities
Aa3	635	-	1	-	-	-
A1	60,616	84	1,251	42,371	19	768
A2	4,216	16	3	-	-	-
Baa3	1,715	-	450	1,897	-	659
Unrated	10,664	59	24	3,706	4	18
Total	**77,846**	**159**	**1,729**	**47,974**	**23**	**1,445**

Liquidity risk

65. Liquidity risk

Liquidity risk is the risk that the Group will encounter difficulty in meeting its obligations associated with financial liabilities that are settled by delivering cash or another financial asset, or of having to do so at excessive cost. This risk arises from earlier maturities of financial liabilities than financial assets.

66. Liquidity risk management

The Group has instituted a liquidity management policy for the Bank and its subsidiaries formulated by The Risk and Finance Committee.The objective of the liquidity management policy is to ensure, even in times of stress, that sufficient liquid assets and funding capacity are available to meet financial obligations in a timely manner and at reasonable cost. Enforcing this policy has the further objective of minimising fluctuations in liquidity. The Risk and Finance Committee approved changes on the Bank's liquidity management policy in the year 2011. The policy is built on a framework published in Basel III standards on liquidity risk measurement. The Group has started implementation on new liquidity measurements set forward in the framework.

The Group follows liquidity rules set by the Central Bank of Iceland to govern the ratio of weighted liquid assets and liabilities as well as following guidelines no. 1/2008 from the Icelandic Financial Supervisory Authority in Iceland (FME) on best practice for managing liquidity in banking organization. The rules set by the Central Bank require the ratio of weighted assets to weighted liabilities to stay above 1 for the next three months, and involve a stress test, weighting assets and liabilities with specific coefficients and reflecting how accessible each asset would be in a liquidity crisis and how great the need would be to repay the liability in question when due. The guidelines set by the Icelandic Financial Supervisory Authority require the ratio of core liquid assets to deposits to stay above 20%. It shows the ratio of deposits that the Group could deliver on demand without incurring any significant losses. The Group submits monthly reports on its liquidity position to the Central Bank of Iceland and the Icelandic Financial Supervisory Authority.

Group liquidity risk is managed centrally by Treasury and is monitored by ALM Risk. This allows management to monitor and manage liquidity risk throughout the Group. The Risk and Finance Committee monitors the Group's liquidity risk, while the Group's internal audit assesses whether the liquidity management process is designed properly and operating effectively.

The Group monitors intraday liquidity risk, short-term liquidity risk, and risk arising from mismatches of longer term assets and liabilities. Short-term liquidity risk is defined as under 12 months. The Group has neither defaulted on any principal or interest nor breached any covenants in respect of liabilities, that could lead such liabilities to be accelerated, up to the date of these consolidated financial statements being authorised for issue.

The Group’s liquidity management process includes projecting expected cash flows in a maturity profile rather than relying merely on contractual maturities, monitoring balance sheet liquidity, monitoring and managing the maturity profile of liabilities and off-balance sheet commitments, monitoring the concentration of liquidity risk in order to avoid undue reliance on large individual depositors, projecting cash flows arising from future business, and maintaining liquidity and contingency plans which outline measures to take in the event of difficulties arising from liquidity crisis.

All amounts are in ISK million

66. Liquidity risk management (continued)

The ALM Risk conducts stress tests by applying various hypothetical scenarios on the Group's liquidity position to ensure that it has adequate liquidity to withstand stressed conditions. Different assumptions are drawn for each stress test to estimate the impact of a variety of market conditions, in particular the lifting of capital controls in Iceland and how that would impact the Group's deposit base.

The key measure used by the Group for monitoring liquidity risk is the ratio of core liquid assets to deposits, which shows the ratio of deposits that the Group could deliver on demand without incurring any significant losses due to forced asset sales or other costly actions. Core liquid assets are comprised of cash at hand, balances with Central Bank, loans to financial institutions (maturity within seven days) and assets eligible for repo transactions with Central Bank (such as government bonds). The core liquidity ratio as at 31 December 2011 was 43% (31 December 2010: 46%) The Group has set a minimum risk appetite for core liquidity ratio at 25%.

67. Deposit stickiness

Stickiness is a method that is used to estimate how stable the deposits of the Group are. The Bank for International Settlements (BIS) defines stickiness as tendency of funding not to run off quickly under stress. The Bank has categorised its deposit base into eight different groups it believes represent different levels of stickiness. The groups are based on Basel III's LCR methodology and are reflected in the Bank's internal liquidity stress tests where a concentration charge is applied to account for possible outflows.

The defining criteria for the groups are as follows:

		2011		2010	
Groups	**Criteria**	**% of total**	**Amount**	**% of total**	**Amount**
Individuals	Individuals	40.6%	226,132	41.3%	214,112
Small and medium size corporates	Businesses that have less than ISK 158.8 million (1 million EUR) in deposits	9.5%	52,999	9.5%	49,332
Large corporates	Businesses that have greater than or equal to ISK 158.8 million (1 million EUR) in deposits	24.5%	136,327	17.0%	88,393
Financial institutions in resolution process	Financial institutions in resolution process	5.4%	29,995	6.5%	33,498
Government, municipalities and Central Bank	Government, municipalities and Central Bank	4.4%	24,604	3.4%	17,535
Financial institutions	Financial institutions	14.9%	82,881	22.0%	113,981
Foreign counterparties other than financial institutions	Businesses with residency outside of Iceland	0.6%	3,528	0.4%	2,185
Total		**100%**	**556,466**	**100%**	**519,036**

The table above shows the deposit base split between different groups at year-end 2011 and 2010.

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68. Maturity analysis of financial assets and liabilities

The following table shows a maturity analysis of the Group's financial instruments as at 31 December 2011:

Non-derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total	Carrying amount
Cash and balances with Central Bank	8,823	-	-	-	-	8,823	8,823
Bonds and debt instruments	-	59,081	9,893	37,571	146,843	253,388	221,848
Loans and advances to financial institutions	-	93,179	5,654	1,397	7	100,237	100,133
Loans and advances to customers	62,090	75,903	124,517	302,650	403,888	969,048	639,130
Other financial assets	-	3,852	-	470	-	4,322	4,321
Total	**70,913**	**232,015**	**140,064**	**342,088**	**550,738**	**1,335,818**	**974,255**
Derivative financial assets							
Gross settled derivatives							
Inflow	-	12,624	-	-	-	12,624	
Outflow	-	(12,490)	-	-	-	(12,490)	
Total	0	134	0	0	0	134	143
Net settled derivatives	-	16	-	-	-	16	16
Total	**0**	**150**	**0**	**0**	**0**	**150**	**159**
Non-derivative financial liabilities							
Due to financial institutions and Central Bank	(112,788)	(87)	(8)	(16)	-	(112,899)	(112,876)
Deposits from customers	(344,952)	(43,578)	(31,714)	(24,426)	(4,641)	(449,311)	(443,590)
Short positions	-	(8,538)	-	-	-	(8,538)	(6,187)
Secured bonds	-	(1,934)	(5,838)	(197,905)	(115,753)	(321,430)	(277,076)
Contingent bond	-	-	-	(38,901)	(37,309)	(76,210)	(60,826)
Other financial liabilities	-	(6,623)	-	-	-	(6,623)	(6,623)
Total	**(457,740)**	**(60,760)**	**(37,560)**	**(261,248)**	**(157,703)**	**(975,011)**	**(907,178)**
Off-balance sheet items							
Financial guarantees	(6,500)	(1,379)	(2,984)	(1,472)	-	(12,335)	
Undrawn loan commitments	(27,741)	-	-	-	-	(27,741)	
Undrawn overdraft/credit card commitments	(53,837)	-	-	-	-	(53,837)	
Total	**(88,078)**	**(1,379)**	**(2,984)**	**(1,472)**	**0**	**(93,913)**	
Total non-derivative financial liabilities and off-balance sheet items	**(545,818)**	**(62,139)**	**(40,544)**	**(262,720)**	**(157,703)**	**(1,068,924)**	
Derivative financial liabilities							
Gross settled derivatives							
Inflow	-	57,725	291	1,160	282	59,458	
Outflow	-	(58,988)	(398)	(1,557)	(375)	(61,318)	
Total	0	(1,263)	(107)	(397)	(93)	(1,860)	(1,712)
Net settled derivatives	-	(17)	-	-	-	(17)	(17)
Total	**0**	**(1,280)**	**(107)**	**(397)**	**(93)**	**(1,877)**	**(1,729)**
Net liquidity position	**(474,905)**	**168,746**	**99,413**	**78,971**	**392,942**	**265,167**	

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68. Maturity analysis of financial assets and liabilities (continued)

The following table shows a maturity analysis of the Group's financial instruments as at 31 December 2010:

Non-derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total	Carrying amount
Cash and balances with Central Bank	47,777	-	-	-	-	47,777	47,777
Bonds and debt instruments	-	10,477	6,438	36,933	168,203	222,051	161,559
Loans and advances to financial institutions	-	88,965	3,051	-	-	92,016	91,882
Loans and advances to customers	79,898	70,129	105,193	247,400	385,138	887,758	592,954
Other financial assets	-	6,313	-	757	-	7,070	7,070
Total	**127,675**	**175,884**	**114,682**	**285,090**	**553,341**	**1,256,672**	**901,242**
Derivative financial assets							
Gross settled derivatives							
Inflow	-	5,482	-	-	-	5,482	
Outflow	-	(5,366)	-	-	-	(5,366)	
Total	**0**	**116**	**0**	**0**	**0**	**116**	**20**
Net settled derivatives	-	3	-	-	-	3	3
Total	**0**	**119**	**0**	**0**	**0**	**119**	**23**
Non-derivative financial liabilities							
Due to financial institutions and Central Bank	(138,503)	(8,583)	(421)	-	-	(147,507)	(147,478)
Deposits from customers	(271,977)	(53,196)	(28,715)	(20,309)	-	(374,197)	(371,558)
Short positions	-	(5,889)	-	-	-	(5,889)	(5,675)
Secured bonds	-	(1,588)	(4,865)	(191,171)	(109,193)	(306,817)	(261,313)
Contingent bond	-	-	-	(21,185)	(11,443)	(32,628)	(26,510)
Other financial liabilities	-	(4,237)	-	-	-	(4,237)	(4,237)
Total	**(410,480)**	**(73,493)**	**(34,001)**	**(232,665)**	**(120,636)**	**(871,275)**	**(816,771)**
Off-balance sheet items							
Financial guarantees	(5,188)	(1,099)	(1,854)	(2,092)	-	(10,233)	
Undrawn loan commitments	(26,105)	-	-	-	-	(26,105)	
Debt underwriting commitments	-	(1,090)	-	-	-	(1,090)	
Undrawn overdraft/credit card commitments	(52,943)	-	-	-	-	(52,943)	
Total	**(84,236)**	**(2,189)**	**(1,854)**	**(2,092)**	**0**	**(90,371)**	
Total non-derivative financial liabilities and off-balance sheet items	**(494,716)**	**(75,682)**	**(35,855)**	**(234,757)**	**(120,636)**	**(961,646)**	
Derivative financial liabilities							
Gross settled derivatives							
Inflow	-	20,149	277	1,145	551	22,122	
Outflow	-	(21,266)	(390)	(1,547)	(737)	(23,940)	
Total	**0**	**(1,117)**	**(113)**	**(402)**	**(186)**	**(1,818)**	**(1,428)**
Net settled derivatives	-	17	-	-	-	17	(17)
Total	**0**	**(1,100)**	**(113)**	**(402)**	**(186)**	**(1,801)**	**(1,445)**
Net liquidity position	**(367,041)**	**99,221**	**78,714**	**49,931**	**432,519**	**293,344**	

The tables above only take into account the contractual maturity of the Groups assets and liabilities but does not account for measures that the Group could decide upon to convert assets into cash at hand by liquidation either through sale or participation in Central Bank operations. Furthermore all instant access deposits are categorized as outflows in the first time bucket. The Groups liquidity position can withstand 43% outflow of deposits (see note 66). Further information on the Group's liquidity management can also be found in the fore mentioned note.

The amounts in the maturity analyses as at year-end 2010 and 2011 are allocated to maturity buckets in respect of remaining contractual maturity (i.e. based on the timing of future cash flows according to contractual terms). Exceptions to this are loans and advances to customers and bonds issued by companies in moratorium or in the process of liquidation. For loans and advances to larger customers the Group estimates both the timing and amounts of cash flows by taking into consideration the expected financial restructuring of the customer. For loans and advances to smaller customers the Group estimates the timing of the cash flows based on the contractual terms but the amounts are based on the historical recovery rate. For bonds issued by companies in moratorium or in the process of liquidation the amounts presented are future cash flows estimated as their fair value at the reporting date. Those bonds all fall in time band of 1-5 years.

All amounts are in ISK million

68. Maturity analysis of financial assets and liabilities (continued)

Amounts presented in the maturity analyses are the undiscounted future cash flows receivable and payable by the Group, including both principal and interest cash flows. These amounts differ from the carrying amounts presented in the statement of financial position, which are based on discounted rather than undiscounted future cash flows. If an amount receivable or payable is not fixed, the amount presented in the maturity analyses has been determined by reference to the conditions existing at the reporting date. For example, for inflation-linked assets and liabilities, the Group estimates the inflation related future cash flows using an internally estimated inflation curve based on the Central Bank of Iceland's inflation target for the annualised inflation rate. When there is a choice of when an amount shall be paid, future cash flows are calculated on the basis of the earliest date at which the Group can be required to pay, which is the worst case scenario from Group perspective. An example of this is that demand deposits are included in the earliest time band. Where the Group is committed to have amounts available in instalments, each instalment is allocated to the earliest period in which the Group might be required to pay. Thus undrawn loan commitments are included in the time band together with the earliest date at which such loans may be drawn. For financial guarantee contracts issued by the Group, the amount included in the maturity analysis is the guarantee's maximum amount, allocated to the earliest period in which the guarantee might be called.

Nonetheless, the Group’s expected cash flows on demand deposits vary significantly from the amounts presented in the maturity analyses. Demand deposits from customers have short contractual maturities but are considered a relatively stable financing source with expected maturity exceeding one year, and it is not expected that every committed loan will be drawn down immediately. See Note 67 on deposit stickiness. The Group conducts a weekly stress test to estimate the impact of fluctuating market conditions and deposit withdrawals.

Amounts presented in non-derivative financial assets and non-derivative financial liabilities include all spot deals at year-end 2011 and 2010. When managing liquidity risk the Group regards spot deals as a non-derivative asset or liability.

69. Maturity analysis of financial assets and liabilities by currency

The following table shows a maturity analysis of the Group’s financial instruments by currency of denomination as at 31 December 2011:

Non-derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total	Carrying amount
Total in foreign currencies	16,034	173,674	49,304	119,155	24,912	383,079	359,014
ISK	54,879	58,341	90,760	222,933	525,826	952,739	615,241
Total	**70,913**	**232,015**	**140,064**	**342,088**	**550,738**	**1,335,818**	**974,255**
Derivative financial assets							
Total in foreign currencies	-	2,727	-	-	-	2,727	143
ISK	-	(2,577)	-	-	-	(2,577)	16
Total	**0**	**150**	**0**	**0**	**0**	**150**	**159**
Non-derivative financial liabilities							
Total in foreign currencies	(73,007)	(5,408)	(10,173)	(197,905)	(115,753)	(402,246)	(357,868)
ISK	(384,733)	(55,352)	(27,387)	(63,343)	(41,950)	(572,765)	(549,310)
Total	**(457,740)**	**(60,760)**	**(37,560)**	**(261,248)**	**(157,703)**	**(975,011)**	**(907,178)**
Off-balance sheet items							
Total in foreign currencies	(11,760)	(761)	(2,311)	(109)	-	(14,941)	
ISK	(76,318)	(618)	(673)	(1,363)	-	(78,972)	
Total	**(88,078)**	**(1,379)**	**(2,984)**	**(1,472)**	**0**	**(93,913)**	
Derivative financial liabilities							
Total in foreign currencies	-	(307)	97	397	99	286	(1,712)
ISK	-	(973)	(204)	(794)	(192)	(2,163)	(17)
Total	**0**	**(1,280)**	**(107)**	**(397)**	**(93)**	**(1,877)**	**(1,729)**
Net liquidity position in foreign currencies	**(68,733)**	**169,925**	**36,917**	**(78,462)**	**(90,742)**	**(31,095)**	
Net liquidity position in ISK	**(406,172)**	**(1,179)**	**62,496**	**157,433**	**483,684**	**296,262**	
Net liquidity position	**(474,905)**	**168,746**	**99,413**	**78,971**	**392,942**	**265,167**	

All amounts are in ISK million

69. Maturity analysis of financial assets and liabilities by currency (continued)

The following table shows a maturity analysis of the Group's financial instruments by currency of denomination as at 31 December 2010:

Non-derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	Total	Carrying amount
Total in foreign currencies	23,644	110,991	29,315	71,293	120,314	355,557	249,812
ISK	104,031	64,893	85,367	213,797	433,027	901,115	651,430
Total	**127,675**	**175,884**	**114,682**	**285,090**	**553,341**	**1,256,672**	**901,242**
Derivative financial assets							
Total in foreign currencies	-	287	-	-	-	287	20
ISK	-	(168)	-	-	-	(168)	3
Total	**0**	**119**	**0**	**0**	**0**	**119**	**23**
Non-derivative financial liabilities							
Total in foreign currencies	(49,351)	(3,567)	(6,468)	(191,171)	(109,193)	(359,750)	(314,244)
ISK	(361,129)	(69,926)	(27,533)	(41,494)	(11,443)	(511,525)	(502,527)
Total	**(410,480)**	**(73,493)**	**(34,001)**	**(232,665)**	**(120,636)**	**(871,275)**	**(816,771)**
Off-balance sheet items							
Total in foreign currencies	(12,059)	(567)	(816)	(1,121)	-	(14,563)	
ISK	(72,177)	(1,622)	(1,038)	(971)	-	(75,808)	
Total	**(84,236)**	**(2,189)**	**(1,854)**	**(2,092)**	**0**	**(90,371)**	
Derivative financial liabilities							
Total in foreign currencies	-	(964)	87	377	189	(311)	(1,428)
ISK	-	(136)	(200)	(779)	(375)	(1,490)	(17)
Total	**0**	**(1,100)**	**(113)**	**(402)**	**(186)**	**(1,801)**	**(1,445)**
Net liquidity position in foreign currencies	**(37,766)**	**106,180**	**22,118**	**(120,622)**	**11,310**	**(18,780)**	
Net liquidity position in ISK	**(329,275)**	**(6,959)**	**56,596**	**170,553**	**421,209**	**312,124**	
Net liquidity position	**(367,041)**	**99,221**	**78,714**	**49,931**	**432,519**	**293,344**	

The amounts in the maturity analysis as at 31 December 2011 and 31 December 2010 are allocated to maturity buckets in respect of remaining contractual maturity (i.e. based on the timing of future cash flows according to contractual terms). Exceptions to this are loans and advances to customers and bonds issued by companies in moratorium or in the process of liquidation as disclosed in Note 68.

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Market risk

70. Market risk

Market risk is the risk that the fair value or future cash flows of financial instruments will fluctuate because of changes in market prices. Market risk arises from open positions in currency, equity and interest rate products, all of which are exposed to general and specific market movements and changing volatility levels in market rates and prices, for instance in interest rates, credit spreads, foreign exchange rates and equity prices. Other market risk such as equity price risk and inflation risk, each of which is disclosed in the following notes.

71. Market risk management

The Group separates its exposure to market risk into trading and non-trading portfolios, managing each of them separately. Trading portfolios include positions arising from market-making and proprietary position-taking (i.e. bonds classified as held for trading, equities, unsettled securities trading, derivatives and short positions) within Treasury. Non-trading portfolios include positions arising from the Group's retail and commercial banking operations and proprietary position-taking as part of the Asset and Liability Management (ALM) within Treasury (i.e. loans and advances, deposits and bonds designated as at fair value through profit or loss or classified as loans and receivables). ALM is also responsible for daily liquidity management and therefore hold positions in interest rate related instruments, creating exposure to market risk.

The Board of Directors is responsible for determining the Group's overall risk appetite, including market risk. The CEO of the Bank appoints the Risk and Finance Committee, which is responsible for developing detailed market risk management policies and setting market risk limits. Treasury is responsible for managing market-related positions under the supervision of ALM Risk. The objective of market risk management is to identify, locate and monitor market risk exposures and analysing and reporting to appropriate parties.

Market risks arising from trading and non-trading activities are monitored and reported on a daily, weekly and monthly basis to the head of each business unit along with detailed input to a comprehensive quarterly risk report. The Group's market risk is thereby measured and monitored on a daily basis, and the detailed limits set by the Risk and Finance Committee are monitored by the ALM Risk. Several indicators are used, including daily profits and losses as well as net positions across different attributes such as the currency and issuer.

Risk-weighted assets are determined by applying specific risk weights to Group assets, following methodology developed by the Basel Committee on Banking Supervision. The following table summarises the Group's exposure to market risk at year-end 2011 and 2010:

	2011	2010
Market risk factor	**% of RWA**	**% of RWA**
Equity price risk	7.7%	4.8%
Interest rate risk	2.6%	2.5%
Foreign exchange risk	3.1%	8.5%
Total	**13.4%**	**15.8%**

The currency risk in the Group's trading portfolios is disclosed together with that in its non-trading portfolios in Notes 76-77, together with the related sensitivity analysis.

72. Interest rate risk

The interest rate risk is the risk that the fair value or future cash flow of financial instruments will fluctuate due to changes in market interest rates.

Changes in interest rates for the Group's assets and liabilities, other than those in its trading portfolios, have an impact on its interest rate margin. This risk results primarily from duration mismatch between assets and liabilities.

Interest rate risk is managed principally by monitoring interest rate gaps. Interest rate risk is managed centrally within the Group by the Treasury of the Bank, and is monitored by the ALM Risk. In the current economic environment, the Group has limited access to derivative instruments and other tools for managing interest rate risk.

The following tables summarise the Group's exposure to interest rate risk. The tables include interest-bearing financial assets and liabilities at their carrying amounts, while off-balance sheet amounts are the notional amounts of the derivative instruments (see Note 10). The amounts presented are categorised by the earlier of either the contractual repricing or the maturity date.

All amounts are in ISK million

72. Interest rate risk (continued)

At 31 December 2011	Up to 3 months	3-12 months	1-5 years	Over 5 years	Carrying amount
Financial assets					
Cash and balances with Central Bank	8,823	-	-	-	8,823
Bonds and debt instruments	209,646	4,905	1,112	6,185	221,848
Derivative instruments	159	-	-	-	159
Loans and advances to financial institutions	93,176	5,621	1,329	7	100,133
Loans and advances to customers	507,251	63,844	24,773	43,262	639,130
Other financial assets	3,851	-	470	-	4,321
Total	**822,906**	**74,370**	**27,684**	**49,454**	**974,414**
Financial liabilities					
Due to financial institutions and Central Bank	(112,876)	-	-	-	(112,876)
Deposits from customers	(441,345)	(2,142)	(103)	-	(443,590)
Derivative instruments and short positions	(1,876)	(2,114)	(2,447)	(1,479)	(7,916)
Secured bonds	(277,076)	-	-	-	(277,076)
Contingent bond	(60,826)	-	-	-	(60,826)
Other financial liabilities	(6,623)	-	-	-	(6,623)
Total	**(900,622)**	**(4,256)**	**(2,550)**	**(1,479)**	**(908,907)**
Net on-balance sheet position	(77,716)	70,114	25,134	47,975	65,507
Net off-balance sheet position	808	(539)	(126)	(143)	
Total interest repricing gap	**(76,908)**	**69,575**	**25,008**	**47,832**	

At 31 December 2010	Up to 3 months	3-12 months	1-5 years	Over 5 years	Carrying amount
Financial assets					
Cash and balances with Central Bank	47,777	-	-	-	47,777
Bonds and debt instruments	150,243	108	1,804	9,404	161,559
Derivative instruments	23	-	-	-	23
Loans and advances to financial institutions	88,831	3,051	-	-	91,882
Loans and advances to customers	455,005	61,190	39,372	37,387	592,954
Other financial assets	6,313	-	757	-	7,070
Total	**748,192**	**64,349**	**41,933**	**46,791**	**901,265**
Financial liabilities					
Due to financial institutions and Central Bank	(147,478)	-	-	-	(147,478)
Deposits from customers	(371,558)	-	-	-	(371,558)
Derivative instruments and short positions	(1,514)	(4,123)	(1,482)	-	(7,119)
Secured bonds	(261,313)	-	-	-	(261,313)
Contingent bond	(26,510)	-	-	-	(26,510)
Other financial liabilities	(4,237)	-	-	-	(4,237)
Total	**(812,610)**	**(4,123)**	**(1,482)**	**0**	**(818,215)**
Net on-balance sheet position	(64,418)	60,226	40,451	46,791	83,050
Net off-balance sheet position	886	(117)	(500)	(269)	
Total interest repricing gap	**(63,532)**	**60,109**	**39,951**	**46,522**	

All amounts are in ISK million

73. Sensitivity analysis for trading portfolios

The management of market risk in the trading book is supplemented by monitoring sensitivity of the trading portfolios to various scenarios in equity prices and interest rates.

The following table shows how the Group's profit before tax would have been affected by parallel shifts in interest yield curves through changes in the fair value of its bond trading portfolios at year-end 2010 and 2011 and cash flows for the next 12 months, assuming a constant financial position.

	2011			2010		
Currency (ISK million)	Parallel shift in yield curve in basis points	Effect of downward shift on profit	Effect of upward shift on profit	Parallel shift in yield curve in basis points	Effect of downward shift on profit	Effect of upward shift on profit
ISK, unindexed	100	216	(216)	100	234	(233)
ISK, CPI indexed	50	155	(147)	50	77	(73)
Total		**371**	**(363)**		**311**	**(306)**

The Group's equity would have been affected to the same extent as the income statement, but net of income tax. This is because the increase (decrease) in profit before tax would have affected retained earnings.

The following table shows how the Group's profit before tax would have been affected by a change of +/-10% in the price of equity and equity instruments held by the Group at year-end which are classified into Level 1 and 2 (as defined in Note 7):

	2011		2010	
Currency (ISK million)	Increase	Decrease	Increase	Decrease
ISK	956	(956)	1,033	(1,033)
EUR	6	(6)	-	-
DKK	97	(97)	-	-
SEK	302	(302)	375	(375)
NOK	378	(378)	374	(374)
Other	39	(39)	204	(204)
Total	**1,778**	**(1,778)**	**1,986**	**(1,986)**

The Group's equity would have been affected to the same extent as the income statement, but net of income tax. This is because the increase (decrease) in profit before tax would have affected retained earnings.

The following table shows how the Group's profit before tax would have been affected by a change of +/-10% in the price of equity and equity instruments held by the Group at year-end which are classified into Level 3 (as defined in Note 7):

	2011		2010	
Currency (ISK million)	Increase	Decrease	Increase	Decrease
ISK	1,983	(1,983)	802	(802)
EUR	811	(811)	225	(225)
GBP	1	(1)	-	-
NOK	-	-	21	(21)
Total	**2,795**	**(2,795)**	**1,048**	**(1,048)**

The Group's equity would have been affected to the same extent as the income statement, but net of income tax. This is because the increase (decrease) in profit before tax would have affected retained earnings.

74. Sensitivity analysis for non-trading portfolios

The management of interest rate risk against interest rate gap limits is supplemented by monitoring the sensitivity of financial assets and liabilities to various interest rate scenarios. The Group employs a monthly stress test of the interest rate risk in the Group's overall non-trading net on-balance sheet position. In this test, the interest rate curve is shifted for every currency. The following table shows how the Group's profit before tax would have been affected by a parallel shift in all yield curves, with all other variables kept constant, as related to risk exposure at year-end 2010 and 2011 and cash flows for the next 12 months, assuming a constant financial position.

	2011			2010		
Currency (ISK million)	Parallel shift in yield curve in basis points	Effect of downward shift on profit	Effect of upward shift on profit	Parallel shift in yield curve in basis points	Effect of downward shift on profit	Effect of upward shift on profit
ISK, unindexed	100	(21)	21	100	(108)	108
ISK, CPI indexed	50	(93)	93	50	(17)	17
EUR	20	(18)	18	20	(9)	9
USD	10	(4)	4	10	(7)	7
GBP	20	(1)	1	20	1	(1)
JPY	5	(1)	1	5	(1)	1
CHF	5	(2)	2	5	-	-
Other	10	-	-	10	(1)	1
Total		**(140)**	**140**		**(142)**	**142**

The Group's equity would have been affected to the same extent as the income statement, but net of income tax. This is because the increase (decrease) in profit before tax would have affected retained earnings.

75. CPI indexation risk (all portfolios)

The consumer price index (CPI) indexation risk is the risk that the fair value or future cash flows of CPI-indexed financial instruments may fluctuate due to changes in the Icelandic CPI index. The Group has a considerable imbalance in its CPI-indexed assets and liabilities. The majority of the Group's mortgage loans and consumer loans are indexed to the CPI. The Group tries to meet the imbalance by offering new products e.g. non-indexed housing loans and indexed deposits.

At 31 December 2011 the CPI imbalance, calculated as the difference between CPI-indexed financial assets and liabilities, was ISK 128,958 million (31 December 2010: 94,641 million).

Carrying amount	2011	2010
Assets		
Bonds and debt instruments	10,812	8,119
Loans and advances to customers	217,131	171,017
Total	**227,943**	**179,136**
Liabilities		
Due to financial institutions and Central Bank	(123)	(421)
Deposits from customers	(97,127)	(82,215)
Short positions	(924)	(595)
Total	**(98,174)**	**(83,231)**
Total on-balance sheet position	129,769	95,905
Total off-balance sheet position	(811)	(1,264)
Total CPI indexation balance	**128,958**	**94,641**

Management of the Group's CPI indexation risk is supplemented by monitoring the sensitivity of the Group's overall position in CPI-indexed financial assets and liabilities net on-balance sheet to various inflation/deflation scenarios. As an example, a 1% change in CPI index applied to the inflation risk exposures in existence at 31 December 2011, with no change in other variables, would have changed net interest income by ISK 1,298 million (31 December 2010: 959 million). Group equity would have been affected by the same amount as the income statement, but net of income tax. This is because the increase/decrease in net interest income would have affected retained earnings.

76. Currency risk (all portfolios)

The Group follows the Rules No. 950/2010 on Foreign Exchange Balances, as set by the Central Bank of Iceland. The rules stipulate that an institution's foreign exchange balance (whether long or short) must always be within certain limits in each currency. The Group submits daily reports to the Central Bank with information on its foreign exchange balance.

The rulings of the Icelandic courts over the past year have decreased the uncertainty regarding the denomination currencies of the loan portfolio of the Group. As a result of these rulings the weight of loans in Icelandic krona has increased and, conversely, the weight of loans denominated in foreign currencies has decreased. Consequently, the currency risk of the loan portfolio has decreased to such an extent that the impact of FX-delta has become negligible and the FX-delta is no longer applicable.

77. Concentration of currency risk

The following tables summarise the Group's exposure to currency risk at year-end 2010 and 2011. The off-balance sheet amounts shown are the notional amounts of the Group's derivative instruments, except for FX options which are delta amounts (see Note 10).

Amounts presented under assets and liabilities include all spot deals at year-end 2011. When managing liquidity risk the Group regards spot deals as a non-derivative asset or liability.

As explained in Note 4(i) and 78 in the consolidated financial statement of the Bank as at and for the year ended 31 December 2010, the Group has changed during the year 2010 the accounting for all types of foreign currency lease agreements which are within the scope of law no. 38/2001 and for certain types of foreign currency loan agreements. Based on that change, their carrying amount was no longer included in the carrying amount of loans and advances to customers disclosed by the Group as denominated in foreign currencies. The ruling of the Supreme Court of Iceland from 9 June 2011 (see Note 4(h) in these consolidated financial statements) confirmed that those loans were denominated in Icelandic krona. The ruling has eliminated to a large extent the uncertainty regarding the denomination currencies of the loan portfolio of the Bank and thus the Group's net currency position.

As explained in Note 21 in these consolidated financial statements, a contingent bond shall be issued no later than 31 March 2013 and be denominated in EUR or such other currencies as may be agreed between the Bank and Landsbanki Íslands hf. Using the exchange rate as published by the Central Bank of Iceland on 31 December 2012, the Bank shall convert the final value of the ISK principal balance (subject to an ISK 92 billion cap) into Euros (or such other currencies as the parties have agreed), which Euro (or other currency) amount shall be the new principal balance of the contingent bond. The contingent bond is therefore accounted for in ISK until year-end 2012 and is not reflected in the following table that summarizes the Group's net position in currency at year-end. The carrying amount at year-end 2011 is ISK 61 billion.

At 31 December 2011	EUR	GBP	USD	JPY	CHF	Other	Total
Assets							
Cash and balances with Central Bank	366	137	243	14	36	250	1,046
Bonds and debt instruments	25,163	168	51,947	-	-	-	77,278
Equities and equity instruments	8,167	13	390	-	-	8,085	16,655
Derivative instruments	97	-	46	-	-	-	143
Loans and advances to financial institutions	32,338	17,875	30,768	3,370	865	6,609	91,825
Loans and advances to customers	72,586	12,022	57,930	21,653	17,496	7,103	188,790
Other assets	680	77	125	1	-	18	901
Total	**139,397**	**30,292**	**141,449**	**25,038**	**18,397**	**22,065**	**376,638**
Liabilities							
Due to financial institutions and Central Bank	(1,296)	(1,780)	(1,120)	(357)	(1,414)	(5,140)	(11,107)
Deposits from customers	(18,700)	(4,005)	(37,789)	(428)	(418)	(5,415)	(66,755)
Derivative instruments and short positions	(842)	(513)	(356)	-	(1)	-	(1,712)
Secured bonds	(136,818)	(51,702)	(88,556)	-	-	-	(277,076)
Other liabilities	(1,484)	(184)	(931)	-	(14)	(353)	(2,966)
Total	**(159,140)**	**(58,184)**	**(128,752)**	**(785)**	**(1,847)**	**(10,908)**	**(359,616)**
Net on-balance sheet position	(19,743)	(27,892)	12,697	24,253	16,550	11,157	**17,022**
Net off-balance sheet position	33,880	20,144	(10,812)	(20,437)	(11,269)	(8,494)	**3,012**
Net currency position	**14,137**	**(7,748)**	**1,885**	**3,816**	**5,281**	**2,663**	**20,034**

All amounts are in ISK million

77. Concentration of currency risk (continued)

At 31 December 2010	EUR	GBP	USD	JPY	CHF	Other	Total
Assets							
Cash and balances with Central Bank	461	133	385	10	35	441	1,465
Bonds and debt instruments	2,152	149	9,747	-	-	-	12,048
Equities and equity instruments	2,246	-	625	-	-	8,201	11,072
Derivative instruments	2	1	17	-	-	-	20
Loans and advances to financial institutions	20,428	12,020	34,295	2,094	863	3,138	72,838
Loans and advances to customers	51,846	7,401	54,227	19,850	20,653	9,107	163,084
Other assets	4,467	7	122	1	-	305	4,902
Assets classified as held for sale	9,914	6,397	449	2,218	7	253	19,238
Total	**91,516**	**26,108**	**99,867**	**24,173**	**21,558**	**21,445**	**284,667**
Liabilities							
Due to financial institutions and Central Bank	(1,302)	(2,182)	(6,827)	(303)	(73)	(967)	(11,654)
Deposits from customers	(14,863)	(3,549)	(17,638)	(686)	(436)	(3,792)	(40,964)
Derivative instruments and short positions	(706)	-	(722)	-	-	-	(1,428)
Secured bonds	(130,963)	(48,132)	(82,218)	-	-	-	(261,313)
Other liabilities	(10)	(7)	(1)	-	-	(295)	(313)
Total	**(147,844)**	**(53,870)**	**(107,406)**	**(989)**	**(509)**	**(5,054)**	**(315,672)**
Net on-balance sheet position	(56,328)	(27,762)	(7,539)	23,184	21,049	16,391	**(31,005)**
Net off-balance sheet position	12,322	79	8,150	(6,719)	(13,503)	(354)	**(25)**
Net currency position	**(44,006)**	**(27,683)**	**611**	**16,465**	**7,546**	**16,037**	**(31,030)**
FX-delta on Loans and advances to customers and assets classified as held for sale	95%	96%	97%	78%	78%	92%	
FX-delta adjustments to currency imbalance	(3,088)	(552)	(1,640)	(4,855)	(4,545)	(711)	**(15,391)**
Net effective currency position	**(47,094)**	**(28,235)**	**(1,029)**	**11,610**	**3,001**	**15,326**	**(46,421)**

78. Sensitivity to currency risk

The following table shows how other net operating income would have been affected by a 10% depreciation/appreciation of ISK against each foreign currency, with all other variables held constant. The sensitivity analysis is applied to the Group's overall position in foreign currency on-balance sheet as disclosed in Note 77.

	2011		2010	
Currency (ISK million)	-10%	+10%	-10%	+10%
EUR	1,414	(1,414)	(4,709)	4,709
GBP	(775)	775	(2,824)	2,824
USD	189	(189)	(103)	103
JPY	382	(382)	1,161	(1,161)
CHF	528	(528)	300	(300)
Other	266	(266)	1,533	(1,533)
Total	**2,004**	**(2,004)**	**(4,642)**	**4,642**

The Group's equity would have been affected to the same extent as the income statement, but net of income tax. This is because the increase/decrease in other net operating income would have affected retained earnings.

79. Foreign exchange rates used

The following foreign exchange rates were used by the Group:

	At 31 December 2011	At 31 December 2010	% Change	Average for 1.1-31.12 2011	Average for 1.1-31.12 2010
EUR/ISK	158.80	153.80	3.3%	161.18	162.66
GBP/ISK	190.29	179.09	6.3%	185.68	189.30
USD/ISK	122.22	114.69	6.6%	115.55	122.26
JPY/ISK	1.59	1.41	12.8%	1.45	1.40
CHF/ISK	130.79	122.75	6.5%	131.04	118.01
CAD/ISK	120.24	115.35	4.2%	117.18	118.08
DKK/ISK	21.36	20.63	3.5%	21.64	21.84
NOK/ISK	20.51	19.71	4.1%	20.72	20.26
SEK/ISK	17.81	17.07	4.3%	17.93	17.02

Operational risk

80. Operational risk

Operational risk is the risk of financial losses resulting from the failure or inadequacy of internal processes or systems, from employee error or from external events. Operational risk includes legal risks, but excludes reputational risks. It is therefore inherent in all areas of business activities.

Whereas the executive managing director of each division is responsible for that division's operational risk, the daily management of operational risk is in the hands of general managers of each department. The Bank establishes, maintains and co-ordinates its operational risk management framework on a group level. This framework complies with the Basel Committee's 2011 publication "Principles for the Sound Management of Operational Risk". The Bank ensures that operational risk management stays consistent throughout the Bank by upholding a system of prevention and control that entails detailed procedures, permanent supervision and insurance policies, together with active monitoring by the Internal Audit Department. By managing operational risk in this manner, the Bank intends to ensure that all of the Bank's business units are kept aware of any operational risks, that a robust monitoring system remains in place and that controls are implemented efficiently and effectively.

All amounts are in ISK million