**Landsbankinn hf.**

**(incorporated in Iceland as a limited liability company)**

**ISK 100,000,000,000**

**Covered Bond Programme**

Under this ISK 100,000,000,000 Covered Bond Programme ("Programme"), Landsbankinn hf., ("Issuer") may from time to time issue Covered Bonds ("Covered Bonds") in accordance with the Icelandic Act on Covered Bonds, No. 11/2008 ("Act on Covered Bonds"), any relevant executive orders (*Ice. "stjórnvaldsákvarðanir"*) and appurtenant regulations as may be supplemented, amended, modified or varied from time to time (as well as any judicial decisions and administrative pronouncements, all of which are subject to change, including with retroactive effect), (together "Covered Bonds Legislation") denominated in any currency as determined by the Issuer.

The Covered Bonds may be issued in bearer form ("Bearer Covered Bonds"), registered form ("Registered Covered Bonds"), uncertificated book entry form cleared through the Icelandic Securities Depository ("ISD") or any other clearing system as decided by the Issuer ("VS System Covered Bonds"). The maximum aggregate nominal amount of all Covered Bonds from time to time outstanding under the Programme will not exceed ISK 100,000,000,000 (or its equivalence in other currencies calculated as described herein). The Covered Bonds may be issued on a continuing basis. The Financial Supervisory Authority, Iceland ("FME") granted the Issuer a licence dated 29 April 2013 to issue Covered Bonds. Information regarding the Issuer's licence to issue Covered Bonds is in chapter 7.11 of this Base Prospectus ("Base Prospectus").

This Base Prospectus has been approved by the FME in its capacity as competent authority under the Act on Securities Transactions, No. 108/2007 ("Act on Securities Transactions") as a base prospectus for the purposes of Article 5(4) of Directive 2003/71/EC ("Prospectus Directive") and Article 45 of the Act on Securities Transactions for the purpose of giving information with regard to the issue of Covered Bonds under the Programme. Applications may be made for Covered Bonds issued under the Programme to be admitted to trading on a regulated market for the purposes of Directive 2004/39/EC ("MiFID") which has been implemented in Iceland through the Act on Securities Transactions and Act on Stock Exchanges No. 110/2007 ("Act on Securities Transactions").

Notice of the aggregate nominal amount of Covered Bonds, interest (if any) payable in respect of Covered Bonds, the issue price of Covered Bonds and any other terms and conditions not contained herein which are applicable to each Tranche (as defined in chapter 6) of Covered Bonds will be set out in the Final Terms, which, with respect to Covered Bonds admitted to trading on a regulated market can be found on the Issuer's website, www.landsbankinn.is (http://www.landsbankinn.is/sertryggd-skuldabref).

Prospective investors should have regard to the factors described in the section entitled "Risk Factors" in the Base Prospectus for a discussion of those factors to be considered in connection with an investment in the Covered Bonds.

The Covered Bonds have not been and will not be registered under the U.S. Securities Act of 1933, as amended ("US Securities Act") and are subject to U.S. tax law requirements. Subject to certain exceptions, the Covered Bonds may not be offered, sold or delivered within the United States or to a U.S. person.

The Issuer may decide that Covered Bonds may be issued in a form not contemplated by the Terms and Conditions of the Covered Bonds described herein, in which event, a supplement to the Base Prospectus conforming with Article 46 of the Act on Securites Transactions, will be made available which will describe the effect of the agreement reached in relation to such covered bonds.

**Landsbankinn hf.**

**The date of the Base Prospectus is 3 October 2013.**

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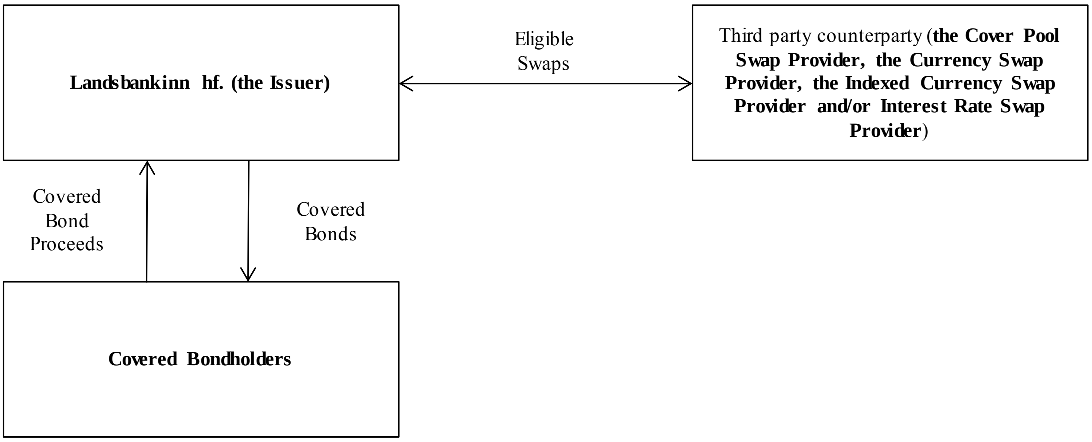
# OVERVIEW OF THE PROGRAMME

The following is a brief overview and it should be read in conjunction with the rest of this Base Prospectus dated 3 October 2013, including any information incorporated by reference, and read together with the Final Terms. This Overview constitutes a general description of the Programme for the purposes of Article 22.5(3) of Commission Regulation (EC) No. 809/2004 implementing the Prospectus Directive.

Words and expressions defined in chapters 6.1 (Definitions) and 2.5.1 (Abbreviations and definitions) of this Base Prospectus shall have the same meanings in this Overview.




**Description:** ISK 100,000,000,000 Covered Bond Programme.

**THE PARTIES:**

**Issuer:** Landsbankinn hf., Reg. No. 471008-0280, registered office at Austurstræti 11, 155 Reykjavík, Iceland.

The Issuer operates pursuant to the provisions of the Act on Financial Undertakings, No. 161/2002, the Act on Public Limited Companies, No. 2/1995 and the Act on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc., No. 125/2008.

The Issuer is a leading Icelandic financial institution with total assets of ISK 1,126 billion at the end of June 2013. The Issuer offers a full range of financial services and is the market leader in the Icelandic financial service sector with the largest branch network, counting 34 branches and outlets.

**Independent Inspector:** The issuer shall appoint an Independent Inspector to supervise the issuance of covered bonds licensed by the FME and the FME must approve his/her appointment in accordance with the Act on Covered Bonds.

The Independent Inspector shall ensure that the Register is properly maintained and updated and shall therefore verify that bonds and derivative agreements are correctly registered; only eligible assets and substitute collateral are included in the cover pool; the value of the assets registered in the cover pool and the valuation thereof is in accordance with the Act on

Covered Bonds and the Rules; that LTV calculations are correctly updated upon significant decrease in the market value of mortgaged assets; and that the matching rules are complied with.

The Independent Inspector shall once a year provide the FME with a written report regarding his/her surveillance. Furthermore, the Independent Inspector shall as soon as possible notify the FME should he/she become aware of any matters which could affect the FME's assessment of the issuer's position in general.

An Independent Inspector to supervise the issuance of the Covered Bonds has been appointed and approved by the FME pursuant to an agreement with PricewaterhouseCoopers ehf. ("PwC").

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| **Cover Pool Swap Provider:** | The Issuer may enter into Cover Pool Swap Agreements with third party counterparties in their respective capacities as cover pool swap provider under a Cover Pool Swap Agreement. A Cover Pool Swap enables the Issuer to convert ISK interest payments (less a client margin) received by the Issuer in respect of assets (other than Swaps) registered to the Cover Pool into floating or fixed payments (as the case may be) payments linked to the interest rate payable on the Covered Bonds. |
| **Currency Swap Provider:** | The Issuer may enter into Currency Swap Agreements with third party counterparties in their respective capacities as currency swap provider under a Currency Swap Agreement. A currency swap enables the Issuer to hedge currency risks arising from (a) Covered Bonds which are issued in currencies other than ISK and (b) assets (other than Mortgage Bonds) which are registered to the Cover Pool and are denominated in currencies other than ISK. |
| **Indexed Currency Swap Providers:** | The Issuer may enter into Indexed Currency Swap Agreements with third party counterparties in their respective capacities as indexed currency swap provider under an Indexed Currency Swap Agreement. Indexed Currency Swaps enable the Issuer to hedge currency and inflation risks arising from (i) Covered Bonds which are issued in currencies other than ISK and not indexed linked and (ii) assets which are registered to the Cover Pool and are denominated in ISK and index linked. |
| **Interest Rate Swap Providers:** | The Issuer may enter into Interest Rate Swap Agreements with third party counterparties in their respective capacities as interest rate swap provider under an Interest Rate Swap Agreement. Interest Rate Swaps enable the Issuer to hedge interest rate risk in ISK and/or other currencies to the extent that these have not already been hedged by the Cover Pool Swap or a Currency Swap. |
| **Fiscal and Transfer Agent** | Landsbankinn hf. or any successor agent appointed as such. |

**KEY FEATURES:**

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| **FME Licensing:** | FME granted the Issuer a licence dated 29 April 2013 to issue Covered Bonds. |

**Status of the Covered Bonds:** The Covered Bonds constitute direct, unconditional, unsubordinated and secured obligations of the Issuer issued in accordance with the Act on Covered Bonds and appurtenant regulations and rank pari passu among themselves and with all other obligations of the Issuer that have been provided the same priority as debt instruments issued pursuant to the Act on Covered Bonds (save for certain obligations required to be preferred by law) (other than subordinated obligations, if any), from time to time outstanding. Senior Debt (if any) ranks thereafter. To the extent that claims in relation to the Covered Bonds, related derivative contracts and Senior Debt (if any) are not met out of the assets of the Cover Pool or the proceeds arising from it, the residual claims will rank pari passu with the claims of all other unsubordinated creditors of the Issuer (other than those preferred by law) in all other respects.

**Issuer Covenants:** ***Negative Pledge***

In accordance with the Act on Covered Bonds, the Issuer undertakes, so long as any of the Covered Bonds, Receipts or Coupons remain outstanding, that it will not, and that it will procure that none of its Relevant Subsidiaries will, create or have outstanding any mortgage, charge, pledge, lien or other security interest over the assets in the Cover Pool, other than any lien arising by operation of law (if any).

***Maintenance of the Issuer's Cover Pool***

For so long as the Covered Bonds are outstanding, the value of the Cover Pool will not at any time be less than the total aggregate outstanding principal amount of all Covered Bonds issued under the Programme plus an Overcollateralization of 20 per cent.

For the avoidance of doubt, the Issuer shall not at any time reduce the Overcollateralization which applies to the Programme if to do so would result in any credit rating then applying to the Covered Bonds by any rating agency appointed by the Issuer in respect of the Covered Bonds being reduced, removed, suspended or placed on credit watch.

***Composition of the Issuer's Cover Pool***

For so long as any of the Covered Bonds are outstanding the Issuer shall ensure that the Cover Pool maintained or to be maintained by the Issuer shall at all times comply with the requirements of the Act on Covered Bonds.

***Interest Cover***

The amounts of interest received by the Issuer in respect of the Cover Pool and under the related derivative contracts entered into by the Issuer shall be at least equal to or exceed the amounts payable by the Issuer under the Covered Bonds and the related derivative contracts entered into by the Issuer.

**The Register:** The issuer of covered bonds must maintain a Register of the issued covered bonds, and the cover pool, together with related derivative agreements in accordance with the Act on Covered Bonds. The Register must, among other things include the following information; (1) the nominal value, interest terms, and final maturity of the covered bonds; (2) the types of assets in the cover pool; and (3) in respect of each mortgage bond in the cover pool, the name of the underlying borrower, their ID./Reg. No., the nominal value of the loan, date of issue, maturity, terms of instalments and interest. Furthermore, the Register shall show the appraisal of the collateral security in the cover pool, when the appraisal was carried out and the premises used. Bonds in a cover pool must be endorsed showing they are part of a cover pool and have been entered into the Register as provided for in Chapter VI of the Act on Covered Bonds. The endorsement shall also indicate that the debt instrument is to secure priority rights of a specific class of covered bonds.

In the event of bankruptcy of an issuer of covered bonds, covered bondholders and derivative agreement counterparties are entitled to rights of priority to the assets in the cover pool that are registered in the Register, as well as over the funds that originate from those assets.

**Composition of the Cover Pool:** Requirements for assets that make up the Cover Pool are set out in the Act on Covered Bonds. A cover pool will consist of assets, which include bonds secured by various types of mortgages, on other registered assets, bonds granted to or guaranteed by certain governmental bodies ("Government Bonds"), receivables in the form of certain derivative agreements and substitute collateral. Assets in the cover pool are to be kept separate from other business operations of the issuer.

**Currencies:** The Covered Bonds may be issued in any currency as determined by the Issuer.

**Form of the Covered Bonds:** The Covered Bonds will be issued in bearer form (the Bearer Covered Bonds), registered form (the Registered Covered Bonds), or, in the case of VS System Covered Bonds, uncertificated book entry form, as specified in the applicable Final Terms and, in the case of definitive Covered Bonds, serially numbered, in the Specified Currency and the Specified Denomination(s). The Covered Bonds will be in the Specified Currency and the Specified Denomination(s). Covered Bonds of one Specified Denomination may not be exchanged for Covered Bonds of another Specified Denomination.

The Covered Bonds may take the form of an Inflation Linked Annuity Covered Bond, an Inflation Linked Equal Principal Payment Covered Bond, a Fixed Rate Covered Bond, a Floating Rate Covered Bond, a Zero Coupon Covered Bond or a combination of any of the foregoing, depending upon the Interest Basis and Redemption/Payment Basis shown in the applicable Final Terms.

**Terms of the Covered Bonds:** The terms of the Covered Bonds will be set out in the Terms and Conditions of the Covered Bonds, as completed by the Applicable Final Terms.

**Redenomination:** Where redenomination is specified in the applicable Final Terms as being applicable, the Issuer may redenominate certain Covered Bonds in euro or other Specified Currency. The relevant provisions applicable to such redenomination are contained in Condition 6.5 of the Terms and Conditions of the Covered Bonds.

**Maturities:** The Maturity Date of the Covered Bonds is specified in the applicable Final

Terms.

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| **Extendable obligations under the Covered Bonds:** | Following the failure by the Issuer to pay the Final Redemption Amount of a Series of Covered Bonds on their Maturity Date, payment of such amounts shall be automatically deferred. This will occur if the Final Terms for a relevant Series of Covered Bonds provides that such Covered Bonds are subject to an extended maturity date on which the payment of all or (as applicable) part of the Final Redemption Amount payable on the Maturity Date will be deferred in the event that the Final Redemption Amount is not paid in full on the Maturity Date (the "Extended Maturity Date").<br><br>To the extent that the Issuer has sufficient funds available to pay in part the relevant Final Redemption Amount in respect of the relevant Series of Covered Bonds, the Issuer shall make partial payment of the relevant Final Redemption Amount as described in Condition 6.8.12 f). Payment of all unpaid amounts shall be deferred automatically until the applicable Extended Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date thereafter up to (and including) the relevant Extended Maturity Date.<br><br>The Issuer is not required to notify the Covered Bondholders of such automatic deferral. The Extended Maturity Date and the applicable interest rate will be specified in the relevant Final Terms. Interest will continue to accrue on any unpaid amount and be payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date. In these circumstances, failure by the Issuer to make payment in respect of the Final Redemption Amount on the Maturity Date shall not constitute a default in payment by the Issuer. However, failure by the Issuer to pay the Final Redemption Amount or the balance thereof on the Extended Final Maturity Date and/or interest on such amount on any Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date shall constitute a default in payment by the Issuer.<br><br>Furthermore, in relation to all amounts constituting accrued interest due and payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date, as provided in the applicable Final Terms, the Issuer may pay such interest pursuant to the Floating Rate set out in the applicable Final Terms notwithstanding that the relevant Covered Bond was a Fixed Rate Covered Bond as at its relevant Issue Date.<br><br>In addition, following deferral of the Maturity Date, the Interest Payment Dates and Interest Periods may change as set out in the applicable Final Terms. |
| **Issue Price:** | The issue price is set out in the applicable final terms and is generally expressed as a percentage of the nominal amount of the Covered Bonds, at which a Tranche of Covered Bonds will be issued. |
| **Interest:** | The Covered Bonds may take the form of an Inflation Linked Annuity Covered Bond, an Inflation Linked Equal Principal Payment Covered Bond, a Fixed Rate Covered Bond, a Floating Rate Covered Bond, a Zero Coupon Covered Bond or a combination of any of the foregoing, depending upon the Interest Basis and Redemption/Payment Basis shown in the applicable Final |

Terms.

Interest periods, rates of interest and the terms of and/or amounts payable on redemption may differ depending on the Covered Bonds being issued and such terms will be specified in the applicable Final Terms.

**Inflation Linked Annuity Covered Bonds:** Inflation Linked Annuity Covered Bonds pay an Annuity Amount on such date or dates as decided by the Issuer and set out in the Final Terms. Calculation of Principal Payments, Interest Payments and Index Ratio are as set out in the Final Terms.

**Inflation Linked Equal Principal Payment Covered Bonds including Covered Bonds with one Payment of Principal on Maturity Date:** Inflation Linked Equal Principal Payment Covered Bonds pay an Equal Payment Amount on such date or dates as decided by the Issuer and set out in the Final Terms. Calculation of Principal Payments, Interest Payments, Principal Amount Outstanding and Index Ratio are as set out in the Final Terms.

**Fixed Rate Covered Bonds:** Fixed Rate Covered Bonds pay a fixed rate of interest on such date or dates as may be agreed between the Issuer and the relevant Dealer as specified in the applicable Final Terms and on redemption calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer.

**Floating Rate Covered Bonds:** Floating Rate Covered Bonds bear interest at a rate determined:

(i) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the ISDA Definitions; or

(ii) on the basis of a reference rate appearing on the agreed screen page of a commercial quotation service; or

(iii) on such other basis as may be agreed between the Issuer and the relevant Dealer, or as set out in the applicable Final Terms.

**Zero Coupon Covered Bonds:** Zero Coupon Covered Bonds will be offered and sold at a discount to their nominal amount and will not bear interest.

**Redemption:** Unless previously redeemed or purchased and cancelled, each Inflation Linked Annuity Covered Bond and each Inflation Linked Equal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date, will, subject to Condition 6.7.1(a) or (b) (as applicable), be redeemed in one or more amounts, calculated in accordance with the formula specified in the applicable Final Terms, in the relevant Specified Currency on the relevant Interest Payment Dates.

If an Issuer Call or Investor Put is specified in the applicable Final Terms, the Issuer or Covered Bondholder may redeem all or some only of the Covered Bonds then outstanding on any Optional Redemption Date as set forth in Terms and Conditions and applicable Final Terms of the Covered Bonds.

If the Covered Bonds become illegal and/or invalid, the Covered Bonds of all Series may be redeemed at the option of the Issuer in whole, but not in part, at any time as set forth in the Terms and Conditions of the Covered

Bonds.

**Denomination of Covered Bonds:** In respect of a Series of Covered Bonds, the denomination or denominations of such Covered Bonds are at the minimum amount of EUR 100,000 as specified in the applicable Final Terms.

**Taxation:** All payments of principal and interest in respect of the Covered Bonds and Coupons by the Issuer will be made without, or deduction for or on account of, any present or future taxes, duties assessments or governmental charges of whatever nature imposed or levied by or on behalf of Iceland or any political subdivision or any authority or agency thereof or therein having power to tax unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amount as shall be necessary in order that the net amounts received by the holders of the Covered Bonds and Coupons after such withholding or deduction shall equal the respective amounts of principal and interest which would otherwise have been receivable in respect of the Covered Bonds or Coupons, as the case may be, in the absence of such withholding or deduction, except that no such additional amounts shall be payable with respect to any Covered Bond or Coupon:

a) in respect of any demand made for payment in Iceland; or

b) in respect of any demand made for payment by or on behalf of a holder who is liable for such taxes, duties, assessments or governmental charges in respect of such Covered Bond or Coupon by reason of it having some connection with Iceland other than the mere holding of such Covered Bond or Coupon; or

c) in respect of any demand made for payment more than thirty days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on making such demand for payment on or before the expiry of such period of thirty days; or

d) in respect of any demand made for payment by or on behalf of a holder who would be able to avoid such withholding or deduction by making a demand in respect of the Covered Bond or Coupon to another Paying Agent in a Member State of the European Union.

where such withholding or deduction is required to be made based on provisions of the Act on Withholding of Public Levies at Source No. 45/1987, as amended, the Act on Withholding of Tax on Financial Income No. 94/1996, as amended, and Article 3 of the Income Tax Act No. 90/2003 (“ITA“), and any other legislation, laws or regulations, replacing or supplementing the same.

**Insolvency of the Issuer:** In the event of insolvency of the Issuer, the Covered Bonds remain outstanding in accordance with the Terms and Conditions of the Covered Bonds.

In the event of bankruptcy of an issuer of covered bonds, covered

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| | bondholders and derivative agreement counterparties are entitled to rights of priority to the assets in the cover pool that are registered in the Register, as well as over the funds that originate from those assets. |
| **Use of Proceeds:** | The net proceeds for each issue of Covered Bonds will be for general funding purposes of the Issuer or other if stated in the Final Terms. |
| **Rating:** | Covered Bonds issued under the Programme may or may not have a rating by a rating agency as stated in the applicable Final Terms. |
| **Clearing Systems:** | Covered Bonds issued under the Programme will be cleared through the ISD, Euroclear, Clearstream, Luxembourg and/or any other clearing system as specified in the relevant Final Terms. |
| **Listing:** | Covered Bonds may be admitted to trading on a r egulated market as specified in the applicable Final Terms. FME has approved this Base Prospectus and an application has been made for Covered Bonds issued under the Programme to be admitted to trading on NASDAQ OMX Iceland. |
| **Governing law:** | The Covered Bonds (except for the ISD System Covered Bonds), the Receipts, the Coupons are governed by, and shall be construed in accordance with, English law except for Condition 6.3 (Status of Covered Bonds), which will be governed by, and construed in accordance with Icelandic Law.<br><br>The Issuer irrevocably agrees that any dispute arising out of the Programme, the Covered Bonds, the Coupons, the Receipts shall be subject to the exclusive jurisdiction of the Courts of England.<br><br>The ISD System Covered Bonds will be governed by, and construed in accordance with Icelandic law. |
| **Risk Factors:** | There are certain risk factors that may affect the Issuer and its ability to fulfill its obligations under Covered Bonds issued under the Programme such as general economic and business conditions in Iceland and globally, credit risk, market risk, liquidity risk, operational risk and legal risk.<br><br>There are certain risk factors that are material for the purpose of assessing the risk of the Covered Bonds issued under the Programme, such as the fact that the Covered Bonds may not be a suitable investment for all investors, legal risk, risks relating to the structure of the Covered Bonds, the Cover Pool and certain market risks. |

# 1 RISK FACTORS

The following factors may affect the ability of Landsbankinn hf., Reg. No. 471008-0280, Austurstræti 11, 155 Reykjavík, Iceland (the "Issuer", the "Bank" and "Landsbankinn") to fulfil its obligations under the Covered Bonds issued under the Programme. Most of these factors are contingencies which may or may not occur and the Issuer is not in a position to express a view on the likelihood of any such contingency occurring.

In addition, factors which are material for the purpose of assessing the market risks associated with Covered Bonds issued under the Programme are also described below.

The Issuer believes that the factors described below represent the principal risks inherent in investing in Covered Bonds issued under the Programme, but the inability of the Issuer to pay interest, principal or other amounts on or in connection with any Covered Bonds may occur for other reasons which may not be considered significant risks by the Issuer based on information currently available to it or which it may not currently be able to anticipate. Prospective investors should also read the detailed information set out elsewhere in this Base Prospectus and draw their own conclusions prior to making any investment decision.

## 1.1 Risks relating to the Issuer, including its business and the ability of the Issuer to fulfil its obligations under the Covered Bond Programme.

As a result of its business activities, the Issuer is exposed to a variety of risks, the most significant of which are credit risk, market risk, liquidity risk and operational risk. Failure to control these risks could result in material adverse effects on the Issuer's business, financial condition and operating results.

### *1.1.1 Financial conditions in Iceland and globally*

The Issuer's financial results are significantly affected by general economic and other business conditions in Iceland and globally. These conditions include changing economic cycles that affect demand for investment and banking products. These cycles are also influenced by global political events, such as terrorist acts, war and other hostilities as well as by market-specific events, such as shifts in consumer confidence and consumer spending, the rate of unemployment, industrial output, labour or social unrest and political uncertainty.

The Issuer's business activities are dependent on the level of banking, finance and financial services required by its customers. In particular, levels of borrowing depend on customer confidence, employment trends, state of the economy and market interest rates at each time. As the Issuer currently conducts most of its business in Iceland, its performance is influenced by the level and cyclical nature of business activity in Iceland, which is in turn affected by both domestic and international economic and political events. There can be no assurance that a weakening in the Icelandic economy will not have a material effect on the Issuer's future financial results.

In addition, market perceptions and reports regarding the Icelandic economy or its performance may influence general economic and business conditions in Iceland due to the small size of the Icelandic economy. These perceptions and reports may have an adverse effect on the Issuer's business, financial condition and results of operations.

The Issuer's retail and corporate banking business may be affected during recessionary conditions, as there may be less demand for loan products or certain customers may face financial problems and the Issuer may experience higher loan defaults. The impact of the economy and business climate on the credit quality of borrowers and counterparties can affect the recoverability of loans and amounts due from counterparties. Interest rate increases also may also impact the demand for mortgages and other loan products and credit quality. The Issuer's investment banking, securities trading, asset management and private banking services, as well as its investments in, and sales of products linked to, financial assets, will be affected by several factors, such as the liquidity of global financial markets, the level and volatility of equity prices and interest rates, investor sentiment, inflation and the availability and cost of credit, which are related to the economic cycle. These conditions may have an adverse effect on the Issuer's business, financial condition and results of operations.

### *1.1.2 Credit Risk*

Granting of credit is the Issuer's major source of income and credit risk is the Issuer's most significant risk factor. Credit risk is defined as the risk that a party to a financial instrument, be it a client, customer or market counterparty will cause a financial loss to the Issuer by failing to fulfil its obligations. Should one or more of the

Issuer's counterparties fail to fulfil its obligations it may result in material adverse effects on the Issuer's business, financial condition and operating results.

Information on the Issuer's credit risk as at 30 June 2013 is provided in chapters 1.8.2.7-1.8.2.10.

Adverse changes in the credit quality of the Issuer's customers and counterparties or a general deterioration in Icelandic or global economic conditions, or arising from systematic risks in the financial systems, could affect the recoverability and value of the Issuer's assets and require an increase in the Issuer's provision for bad and doubtful debts and other provisions. Specific issues and events where credit risk could adversely affect revenues in 2013 and subsequent years include but are not limited to:

#### *1.1.2.1 Concentration of loan portfolio in certain sectors could adversely affect the Issuer*

The Issuer's loan portfolio is relatively concentrated in key sectors. These are households, fisheries and construction and real estate companies. Downturns in these sectors that would influence customers' ability to meet their obligations may have an adverse effect on the Issuer's business, financial condition and operating results. Information on the key sectors of the Issuer's loan portfolio is provided in chapter 1.8.2.7.

#### *1.1.2.2 Deterioration of economic conditions could increase the required loan impairment for the Issuer*

Higher unemployment, reduced personal disposable income levels and increased personal and corporate insolvency rates may reduce customers' ability to repay loans. This, in addition to depressed asset valuations could have an impact on the adequacy of the Issuer's loss reserves and future impairment charges.

#### *1.1.2.3 Renegotiated loans*

Financial restructuring and renegotiation of loans to the Issuer's customers acquired from LBI hf., formerly Landsbanki Íslands hf., Reg. No. 540291-2259, Álfheimar 74, 104 Reykjavík Iceland, started in 2009. In regard to the financial restructuring of customers, the Issuer 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 2011 and 2012, the Issuer continued its focus and effort in restructuring loans to individuals and companies.

The loans acquired from LBI hf. cause uncertainty about the net expected future cash flows from the loans due to various reasons. The biggest contributing factor is the effect of the financial crisis and high number of restructured loans.

### *1.1.3 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.

The most significant market risks that the Issuer faces are equity, interest rate, foreign exchange and indexation risks. Changes in interest rate levels, inflation, yield curves and spreads may affect the interest rate margin realised between lending and borrowing costs. Changes in currency rates affect the value of assets and liabilities denominated in foreign currencies and may affect income from foreign exchange dealing. The performance of financial markets may cause changes in the value of the Issuer's investment and trading portfolios.

#### *1.1.3.1 Equity risk*

Equity risk includes risks connected with changes in the Issuer's equity portfolio as a result of changes in the market value of equities. The Issuer's equity risk comes from both proprietary and securities trading.

The Issuer has an exposure to equity risk and elevated uncertainty in the financial markets could possibly lead to increased volatility in the equity markets. This could lead to a devaluation of equities and investment funds held by the Issuer and have an adverse effect on the Issuer's business, financial condition and operating results.

The Issuer's exposure to equity risk amounted to 5.9% of risk-weighted assets ("RWA") as of 30 June 2013.

#### *1.1.3.2 Interest rate risk*

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. The Issuer's interest rate risk arises from the impact of interest rate changes on the Issuer’s assets and liabilities. Since a major portion of the Issuer’s assets and liabilities are interest-related in one manner or another.

The Issuer’s limited access to debt markets could have a negative effect on the Issuer’s revenues as it may be unable to correct interest rate imbalances between assets and liabilities, based on the timing of interest rate reset or maturity. For example risks can arise if there are fixed and variable interest rate items in the same maturity bracket; this may lead to open interest rate positions on the assets or liabilities side. This could then affect the Issuer’s profitability. The Issuer may also be limited in his ability to adjust interest rates applied to customers due to competitive pressures.

The Issuer’s exposure to interest rate risk amounted to 4.0% of RWA as of 30 June 2013. Information on the Issuer’s interest rate risk as at 30 June 2013 is provided in chapter 1.8.4.1.

#### *1.1.3.3 Foreign exchange risk*

Foreign exchange risk is the financial risk posed by an exposure to unanticipated changes in the exchange rate between currencies.

The Issuer follows Rules No. 950/2010 on Foreign Exchange Balances, as set by the Central Bank of Iceland (“Rules on Foreign Exchange Balances”). The Rules on Foreign Exchange Balances stipulate that an institution’s foreign exchange balance (whether long or short) must always be within 15% of the Issuer’s capital base, in each currency and for all currencies combined.

The Issuer’s exposure to foreign exchange risk amounted to 1.7% of RWA as of 30 June 2013. Information on the Issuer’s currency risk as at 30 June 2013 is provided in chapter 1.8.4.5.

#### *1.1.3.4 The Issuer may be affected by volatility in the foreign exchange market*

The Issuer’s combined net foreign exchange balance as of 30 June 2013 was 2.28% of the Issuer’s capital base. Uncertainty regarding currency denomination in the Issuer’s loan portfolio has not been fully resolved in the period 1 January-30 June 2013. As explained in chapter 1.1.6 on Legal risk below there are a few litigations pending concerning these currency denominations that the Icelandic courts have not passed judgement on yet.

Increased volatility in the foreign exchange markets could have an adverse effect on the Issuer’s business, financial condition and operating results. Net operating income in 2012 would have been positively/negatively impacted to the amount of ISK 2,004 billion with a 10% depreciation/appreciation of the ISK against each foreign currency, with all other variables held constant.

#### *1.1.3.5 Indexation risk*

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. The Issuer has a considerable imbalance in its CPI-indexed assets and liabilities. The majority of the Issuer’s mortgage loans and consumer loans are indexed to the CPI.

Information on the Issuer’s CPI indexation risk as at 30 June 2013 is provided in chapter 1.8.4.4.

#### *1.1.3.6 The Issuer may have limited opportunities to hedge imbalances in the CPI indexed assets and liabilities*

The Issuer has a considerable imbalance in its CPI-indexed assets and liabilities with CPI-indexed assets over ISK 174 billion at 30 June 2013 (net of liabilities). In the case of deflation in the CPI there could be a corresponding impact on the balance sheet and loss to the Issuer.

As an example, a 1% change in the CPI applied to the existing inflation risk exposures at 31 December 2012, with no change in other variables, would have changed net interest income by ISK 1,462 million. The Issuer’s 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. However, in a scenario of on-going high (low) inflation, floating un-indexed rates are likely to remain higher (lower) than would be the case in the reverse scenario, thus counterbalancing the positive (negative) income effects for the Issuer in the longer term.

### *1.1.4 Liquidity Risk*

Liquidity risk is the risk that the Issuer 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. The Issuer's core liquidity ratio as of 30 June 2013 was 45% and the ratio of cash and cash equivalents to on-demand deposits was 15%.

Information on the Issuer's maturity analysis of financial instruments as at 30 June 2013 is provided in chapter 1.8.3.2.

*1.1.4.1 Failure of the Issuer to refinance the outstanding bonds between LBI hf. and the Issuer could have a negative impact on the Issuer's business*

The Issuer will have to make annual repayments of principal to LBI hf. in foreign currencies of around ISK 18 billion in 2014, 54 billion in 2015 and around ISK 72 billion annually in the years 2016-2018, plus interest. Without renegotiation of these debts or access to refinancing from international credit markets there could be a material adverse effect on the Issuer's business, financial condition and operating results.

On 1 October 2013, the Issuer paid ISK 10 billion as dividends to shareholders in accordance with a resolution adopted at the Issuer´s 2013 Annual Meeting. Prior to the dividend payment the Issuer informed LBI hf. of its view that the dividend payment did not entail any obligation under the terms of the outstanding bonds to make an additional repayment of the bonds due to the fact that the Issuer had on 15 June 2012 made a sufficient optional and partial early redemption of the bonds. In a letter of 2 October 2013 LBI hf. stated that due to the dividend payment the Issuer is required to make an ISK 10 billion principal repayment of the bonds to LBI hf. The Issuer expects that the matter will be resolved between the parties in the forthcoming discussions regarding possible amendments to the Bonds.

On 2 October 2013, the Winding-up Board of LBI hf. agreed to the request from the Issuer to commence discussions on possible amendments to contractual obligations under the Bonds between the Issuer and LBI hf, including, but not limited to, the maturity profile of the Bonds.

*1.1.4.2 Operational Risk*

Operational risk and losses can result from fraud, errors by employees, failure to document transactions properly or to obtain proper internal authorisation, failure to comply with regulatory requirements and business rules, equipment failure, natural disasters or the failure or inadequacy of internal processes or systems or external systems, for example, those of the Issuer's suppliers or counterparties.

The Issuer's business is dependent on the ability to process a very large number of transactions efficiently and accurately. Specific issues and events where operational risk could adversely affect revenues in 2013 and subsequent years include but are not limited to:

*1.1.4.3 Operational risks are inherent in the Issuers business activities and are typical of comparable businesses*

Losses can occur due to flaws in current working procedures or because there are no documented working procedures. A loss can result from human error or because current working procedures were not followed. The Issuer has in place and maintains necessary rules and working procedures and keeps them accessible to all employees on the Issuer's intranet. It is intended to ensure that key information on work processes is available in one place. However, there is no guarantee that mistakes will not be made which might have a material impact on the Issuer's business.

Both current and former employees of the Issuer can damage the Issuer if they infringe its rules either intentionally or through negligence. While it is difficult to evaluate the damage in each instance, the loss can be financial and/or damage the Issuer's reputation.

The Issuer's information systems ("IT systems") comprise a major operational risk, both with regard to their functioning and accessibility. The Issuer's IT systems are varied and in many instances depend upon co-operating partners. Various kinds of external attacks, viruses, denial of service attacks ("DoS attack") or other types of attacks on the Issuer's computer systems could disrupt the Issuer's operations. The Issuer has in place specific disaster recovery and business continuity plans, including backup sites. It is not entirely possible, however, to eliminate operational risk arising from unexpected events.

The Issuer could suffer a loss as a result of criminal actions, such as a bank robbery, fraud, money laundering or embezzlement. All of these risk factors could cause the Issuer extensive damage and affect its performance.

#### *1.1.4.4 Failure to manage compliance risk could adversely affect the Issuer's business*

Compliance is one of the Issuer's support and risk management functions. It is intended to assist in managing the Issuer's compliance risk on a consolidated basis. Compliance risk can be defined as the risk of legal or regulatory sanctions, financial loss or damage to the Issuer's reputation as a result of failure to comply with applicable laws, regulations, codes of conduct and standards of good practice.

Compliance emphasises issues such as market abuse and fraud prevention, anti-money laundering, codes of ethics, avoidance of conflicts of interest and ensuring best practice. The Compliance Officer ensures that the Issuer's rules on securities trading and insider dealing are followed, and that the Issuer's operations comply with the Act on Securities Transactions, the Act on Actions to Combat Money Laundering and Terrorist Financing No. 64/2006 ("Act on Actions to Combat Money Laundering and Terrorist Financing") and other relevant legislation and regulations.

There is however always the risk that the Issuer could suffer if the above-mentioned rules are not followed.

#### *1.1.4.5 The Issuer's future success depends, in part, on its ability to attract, retain and motivate qualified and experienced banking and management personnel*

Competition for personnel with relevant expertise is significant, e.g. due to the relatively small number of available qualified individuals. Failure to attract and retain senior management and key employees could have a material adverse effect on the Issuer's business.

The Issuer's majority owner is the Icelandic government and the Issuer's remuniration policy is determined by the owner. The ability of the Issuer to attract and retain competent personnel could be adversely affected by this. In the Issuer's annual financial report for the year 2012 the Board of Directors of the Issuer highlighted the inherent risk to the Issuer due to the fact that its CEO's salary is determined by the Senior Civil Servants Salary Board (*Ice. "Kjararáð"*). The Senior Civil Servants Salary Board has considered itself not to be authorised to set the CEO salary for regular hours above the nominal salary of the Prime Minister of Iceland. Legal opinions prepared for the Issuer's Board of Directors find that the current arrangement is contrary to the Constitution of Iceland and the Agreement on the European Economic Area.

The Board of Directors has in a letter to the Senior Civil Servants Salary Board formally requested that it determine, by way of a new decision, an acceptable salary and employment terms for the CEO. The matter is under consideration by the Senior Civil Servants Salary Board.

#### *1.1.4.6 Environmental disasters, natural catastrophes and acts of war could have a negative impact on the Issuer's revenues and on-going operation*

Although natural catastrophes and environmental disasters could threaten the Issuer's ability to maintain its operations, attempts are made to limit this risk by ensuring the security of central equipment, its location and distribution between risk areas. The Issuer also has in place specific disaster recovery and business continuity plans.

#### *1.1.4.7 Damage to the Issuer's image could adversely affect its operation*

The image and reputation of financial enterprises are among their most valuable assets. The risk of damage to the Issuer's image or reputation is present whenever it is the subject of discussion. Damage to its image or reputation could prompt the Issuer's customers to direct their business elsewhere. This could have a very negative impact on the Issuer's business. Such damage could result, for instance, from business mistakes, violations of laws or regulations, errors of judgement, and poor service or products offered.

#### *1.1.4.8 The Issuer's financial statements are based in part on assumptions and estimates which, if inaccurate, could lead to future losses*

The preparation of financial statements requires the Issuer's 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 on-going basis. Revisions to accounting estimates are recognised in the period in which the estimates are revised and in any future periods affected. The following estimates and assumptions involve a substantial risk which could result in material adjustments to the carrying amounts of assets and liabilities during the next financial year.

*Effective interest rate on loans and advances*

The Bank acquired loans and advances from LBI 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.

*Impairment losses on loans and advances*

To assess impairment, the Issuer reviews its loan portfolios on at least a quarterly basis. To determine whether an impairment loss should be recognised, the Issuer 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.

*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.

*Financial asset and liability classification*

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

*Assets classified as held for sale*

The Issuer 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 Issuer's control and the Issuer remains committed to its plan to sell the asset (or disposal group).

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

*Deferred tax assets*

Deferred tax assets are recognised in the consolidated statement of financial position. In respect of tax losses carried forward, they are recognized 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.

*Liquidity*

The key measure used by the Issuer 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, such as loans acquired from LBI 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.

If the judgements, estimates and assumptions used by the Issuer in preparing its consolidated financial statements are subsequently found to be incorrect, there could be a material impact on the Issuer's operating results with a corresponding impact on its funding requirements and capital ratios.

#### *1.1.4.9 The Issuer's insurance coverage may not adequately cover all losses*

The Issuer has taken a conscious decision to insure itself against specific risks. The Issuer holds all mandatory insurance coverage, including fire insurance and mandatory vehicle insurance, plus comprehensive vehicle insurance. The Issuer also holds insurance policies provided for in collective bargaining agreements with the Confederation of Icelandic Bank and Finance Employees, such as life and accident insurance, and insurance stipulated by other wage contracts as applicable. In addition, the Issuer has taken out liability insurance against third-party claims, insurance on moveable property and professional liability insurance for its auditor and a directors and officers' liability insurance for the Issuer's directors and senior management. The Issuer also carries insurance against computer crime and professional indemnity coverage. In addition, money transportation is insured in accordance with the interests at stake in each instance. It should be borne in mind, however, that despite the insurance policies carried by the Issuer, there is no guarantee that it will be fully compensated should it need to lodge claims. If the Issuer did submit claims under its policies, the premiums it pays could be expected to increase in the future. The Issuer's insurance policies are subject to terms and conditions of the applicable policies.

#### *1.1.4.10 The Issuer may be exposed to risks that are either not identified or inadequately appraised by present risk management methods*

The Issuer has developed and implemented principles, procedures and rating methods for the monitoring and identification of risks. Nevertheless, even with these monitoring systems in place it is not possible to completely eradicate the Issuer's exposure to risks of various kinds which may not be identified or anticipated. Unanticipated or incorrectly quantified risk exposures could have a material adverse effect on the Issuer's operation. Information regarding the Issuer's risk management is in chapter 1.9 of this Base Prospectus.

### *1.1.5 Legal risk*

The Issuer's business operations are governed by laws and regulations and are subject to regulatory supervision. The Issuer is regulated by the FME. The Issuer's operating license is subject to compliance with laws and regulations governing the Issuer and its operations, and any breach of those laws or regulations may result in severe fines, liability for damages and/or the revocation of the Issuer's license.

The Issuer is subject to a n umber of laws, regulations, administrative actions and policies governing the provision of financial services in Iceland. Any changes to current legislation might affect the Issuer's operations and its operating results. Although the Issuer works closely with regulators and continually monitors its legal position, future changes in regulations, fiscal or other policies can be unpredictable and are beyond the Issuer's control.

Specific issues and events where legal risk could adversely affect revenues in 2013 and subsequent years include but are not limited to:

#### *1.1.5.1 On-going litigation against the Issuer*

The Issuer will at any time be involved in a number of court proceedings which is considered normal due to the nature of the business undertaken. The number of disputes involving the Issuer has been high since its foundation in the wake of the collapse of the Icelandic banking system in October 2008. Below is a description of pending or threatened proceedings against the Issuer which might have a significant effect on the Issuer's financial position or profitability if not ruled in favour of the Issuer.

### *1.1.5.2 Disputes regarding loans indexed to foreign currencies*

In 2010 and 2011 the Supreme Court of Iceland ruled that the principal of a loan agreement denominated in ISK could not be indexed to foreign currencies. Such indexation was deemed contrary to the provisions of the Act on Interest and Price Indexation. The rulings had the effect that a number of such loans had to be recalculated by the Issuer. In accordance with the rulings and applicable law, loans indexed to foreign currencies should bear the lowest interest rates of non-indexed loans denominated in ISK as determined by the Central Bank of Iceland. An impact of these rulings was recognized in the consolidated financial statements of the Issuer as of 31 December 2010.

On 15 February 2012, in case No. 600/2011, the Supreme Court of Iceland ruled that a lender could not apply the Central Bank of Iceland's interest rates under circumstances specified in the ruling, inter alia, as the lender had issued a final receipt of payment. The case did not involve any entity of the Issuer but is nevertheless of relevance to the Issuer.

Legal uncertainty regarding the recalculation of loans indexed to foreign currencies rose following the judgement. As a consequence, the Icelandic Competition Authority on 9 March 2012 allowed cooperation between financial undertakings with the aim to expedite the recalculation of loans indexed to foreign currency. This allowed them inter alia to share views on the interpretation of the ruling from 15 February 2012, discuss methodology on the recalculation of such loans, identify issues which remained unclear and choose new cases with the aim to clarify such issues. Based on this cooperation, 22 issues were identified which would be clarified in 11 cases that were also identified through this cooperation.

The conclusion of Supreme Court case No. 600/2011 was upheld in another judgement by the Supreme Court of 18 October 2012 in case No. 464/2012. Ruling No. 464/2012 clarified the legal uncertainty to a certain extent. Following the ruling the financial undertakings that cooperated as described above have, independent of each other, revisited the court cases they each aimed to instigate and found that some are no longer necessary as certain issues have been resolved by the ruling. The Issuer has decided not to push ahead with two out of four cases which it would otherwise have taken forward. In addition to the cases where the Issuer is the plaintiff, a number of borrowers have following the rulings lodged a claim against the Issuer demanding a recalculation of their loan agreements. Several such cases are being argued before the Icelandic courts or are in the final stages of being submitted to the Icelandic courts. The results of these cases will clarify matters further and enable the Issuer to make an informed decision on which loans should be recalculated and the main issues to be considered as regards the methodology of such recalculations.

Moreover, the conclusions of the Supreme Court in cases No. 600/2011 and 464/2012 were also referred to in a judgement by the Supreme Court of 30 May 2013 in a case No. 50/2013. The case differed from the other cases, inter alia, as it concerned a car loan with shorter maturity than the disputed loans in the other two cases.

The Issuer has accounted for the potential impact of the rulings from 15 February 2012 and 18 October 2012 and recognised respectively expenses in the amount of ISK 38,042 million and ISK 2,120 million in its consolidated income statement at year-end 2012. These expenses are recorded in the income statements under line item "Loss from foreign currency linkage of loans and advances to customers". The precedents set by these rulings are not entirely clear and further court rulings are needed to clarify the issues regarding loans indexed to foreign currencies. The total amount of the estimated impact may change accordingly.

### *1.1.5.3 Disputes regarding loans indexed to the CPI*

A related issue concerns the validity of Icelandic loans indexed to the CPI. A borrower has brought legal proceedings against the Issuer claiming that CPI indexation should be found illegal based on a number of arguments, including that the increase in loan amounts is unjust and can be challenged on the basis of Article 36 of Act No. 7/1936, on Contracts, Agency and Void Legal Instruments ("Act on Contracts etc."). Another argument is that indexation is a form of derivative and should therefore not have been offered to consumers without extensive consulting in accordance with Act on Securities Transactions, which has implemented the requirements of the MiFID.

### *1.1.5.4 Disputes concerning the split between LBI hf. and the Issuer*

A number of former customers of the Issuer's predecessor, LBI hf., have filed law suits against the Issuer in order to claim compensation for alleged mistakes made by LBI hf.'s employees or to have certain agreements deemed null and void. The Issuer has not accepted any liability and will challenge these lawsuits, inter alia on the grounds that these claims relate to events that happened prior to the incorporation of the Issuer and the assignment of certain liabilities and assets on 9 October 2008 and the Issuer and therefore are not the responsibility of the Issuer in any way and that LBI hf. has the right to set-off any undisputed claims.

A few pending cases relate to the transfer of assets from LBI hf. to the Issuer in 2008. One case involves funds received by a foreign bank after that bank had been notified of the transfer of the business from LBI hf. to the Issuer and been instructed that moneys received should be directed to the account of the Issuer, in particular funds owned by clients of the Issuer. The foreign bank continued to channel funds into LBI hf. accounts and refuses to release the funds claiming the right to set the funds off against obligations owed by LBI hf.

There are on-going cases between the Issuer and/or its subsidiaries and LBI hf. In one such case LBI hf. has claimed that the bank's acquisition of bonds from several investment funds operated by Landsvaki hf., now a subsidiary of the Issuer, in the period 1-3 October 2008 as well as on 28 October 2008, should be rescinded and moneys paid refunded. The Issuer is also a party to this case directly as LBI hf. claims it should have a right to set off the claim against Landsvaki hf. to a claim held by the Issuer against LBI hf. Although the total claims by LBI hf. amount to approximately ISK 25 billion the effect is limited to the own funds of Landsvaki hf. (approximately ISK 1 billion) and the amount of the Issuer's claim, or approximately ISK 6 billion.

## 1.2 Risks relating to the Covered Bonds

Set out below is a brief description of risks relating to the Covered Bonds.

### *1.2.1 Legal risk*

The Covered Bonds are governed by law and regulations. Any changes to the current legislation might affect the value of the Covered Bonds. The Act on Covered Bonds provides that the FME may issue rules providing for the types of assets in a cover pool, methods for appraisal of collateral of bonds, terms and conditions for derivative agreements and conditions for the calculation of risk and interest payments. FME has issued such rules, i.e. Rules No. 528/2008, on Covered Bonds (the "Rules") that concern, among other things, the conditions for being granted a licence to issue Covered Bonds, appraisal and revaluation of the assets in the cover pool, matching rules, derivative agreements, the covered bonds register and the eligibility and reporting of the cover pool monitor. Any changes to the Act on Covered Bonds and/or the Rules as well as other current legislation might affect the legal and regulatory risks relating to the Covered Bonds.

The Act on Covered Bonds entered into force on 4 March 2008. To date only a few licenses to issue covered bonds have been granted under the Act and there are no precedents on how its provisions will be interpreted or applied by Icelandic courts or administrative authorities. The preparatory works to the Act on Covered Bonds give limited guidance and the system of Covered Bonds secured by the Cover Pool lacks any clear analogues in Icelandic law that would allow for clear conclusions in respect of the Act, the Covered Bonds or the Cover Pool.

### *1.2.2 Competition risk*

The Issuer operates in a competitive market and increased competition by Icelandic or foreign banks could increase downward pressure on interest rate margins. The Issuer operates in a market which has changed rapidly in recent years, with increased competition. The Issuer's main competitors are Arion Bank hf., Íslandsbanki hf., MP banki hf. and the Icelandic Housing Financing Fund ("HFF"). There is always a risk of new entrants to the market, foreign or domestic or for smaller competitors to merge and increase their strength. Such competition could develop in individual market sectors, or in the market as a whole. The Issuer has a high market share, which it intends to maintain. The Issuer makes every effort to ensure that its product range, service and prices are competitive, and must constantly monitor its competitors and their offerings. However, there is always a risk that the Issuer could lose its competitive edge and that new products could fail to meet the demands of the market or compete with competitors' products. All of the above could undermine the Issuer's income generation and may have an adverse effect on the Issuer's business, financial condition and operating results.

### *1.2.3 Credit risk relating to the Issuer's collateral*

The Cover Pool which will secure the Covered Bonds is comprised of mortgage loans secured on residential property which, at the date of this Base Prospectus, are located in Iceland. These residential mortgage loans may be loans originally made to a borrower for the purpose of buying, constructing, altering or refinancing a residential property in which that borrower then or subsequently resides or may be mortgage loans made to a borrower for the purchase of that residential property for investment, rental or other purposes.

A borrower under a residential loan may default on its obligation under that residential loan. The credit risk relating to the Cover Pool is partly driven by the performance of the real estate and housing market in Iceland. There can be no assurance on the future development of the value of assets in the Cover Pool. Several circumstances may affect the level of credit loss such as changes in the economic climate, both nationally and internationally, changes in market rates, increases in taxation, inflation and changes on political policies etc.

Borrowers may default and their financial standing may deteriorate as a result of, for example, changes in their own personal circumstances such as unemployment, death, illness or relationship status. A decline in the price of real estate and the housing market could adversely affect the Issuer's operating results, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds. Defaults in respect of the Issuer's assets in the Cover Pool under residential mortgage loans could jeopardise the Issuer's ability to make payment in full or on a timely basis on the Covered Bonds. If a substantial part of the assets in the Cover Pool were to default, there is no guarantee that the required level of assets in the Cover Pool could be maintained or that the Issuer would be able to replace the defaulting assets with non-defaulting assets. Any such failures could adversely affect the Issuer's results of operation, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

### *1.2.4 Basel Capital Requirements Directive*

The Basel Committee on Banking Supervision ("Basel Committee") issued the 1988 Capital Accord. The Basel Committee has since published a revised framework in June 2006; "International Convergence of Capital Measurements and Capital Standards: A Revised Framework (Comprehensive Version)", which aims to place enhanced emphasis on market discipline and sensitivity to risk (the "Framework").

In July 2009, the Basel Committee finalised amendments to the Framework, including changes intended to enhance certain securitisation requirements (e.g. increased risk weights for re-securitisation exposures). Collectively, the new global standards to address both firm-specific and broader, systemic risks have been referred to as Basel III. In addition, the European Parliament has approved certain amendments to Capital Requirements Directive 2006/49/EC (the "CRD") (including investment restrictions and put forward further securitisation related amendments to the European Parliament and the Council of Ministers for consideration (including increased capital charges for relevant trading book exposures and for re-securitisation exposures)).

As and when implemented, Basel III (and any relevant changes to it or to any relevant implementing measures) may affect the risk-weighting of the Covered Bonds for investors who are subject to capital adequacy requirements that follow the Framework. The Issuer cannot predict the precise effects of changes that might result from implementation of the Framework, whether on its own financial performance or on the pricing of the Covered Bonds. Consequently, prospective investors of the Covered Bonds should consult their own advisors as to the implications for them of the application of the Framework and any relevant implementing measures such as resulting from Basel III.

### *1.2.5 U.S. Foreign Account Tax Compliance Withholding*

The Issuer and other non-U.S. financial institutions through which payments on the Covered Bonds are made may be required to withhold U.S. tax at a rate of 30 per cent. on all, or a portion of, payments made after 31 December 2014 in respect of (i) any Covered Bonds issued after 18 March 2012 and (ii) any Covered Bonds which are treated as equity for U.S. federal tax purposes, whenever issued, pursuant to the U.S. Foreign Account Tax Compliance Act ("FATCA"). This withholding tax may be triggered if (i) the Issuer is a foreign financial institution ("FFI") (as defined in FATCA) which enters into and complies with an agreement with the U.S. Internal Revenue Service ("IRS") to provide certain information on its account holders (a term which includes the holders of its debt or equity interests that are not regularly traded on an established securities market) (making the Issuer a "Participating FFI"), (ii) the Issuer has a positive "pass-through percentage" (as defined in FATCA), and (iii)(a) an investor does not provide information sufficient for the Participating FFI to determine whether the investor is a U.S. person or should otherwise be treated as holding a "United States Account" of the Issuer, or (b) any FFI through which payment on such Covered Bonds is made is not a Participating FFI.

The application of FATCA to interest, principal or other amounts paid with respect to the Covered Bonds is not clear. If an amount in respect of U.S. withholding tax were to be deducted or withheld from interest, principal or other payments on the Covered Bonds as a result of a holder's failure to comply with these rules or as a result of the presence in the payment chain of a non-Participating FFI, neither the Issuer nor any paying agent nor any other person would, pursuant to the Conditions of the Covered Bonds be required to pay additional amounts as a result of the deduction or withholding of such tax other than in respect of payments as to which the withholding would not have been required had the Issuer's Agent receiving the payment been a Participating FFI. As a result, investors may, if FATCA is implemented as currently proposed by the IRS, receive less interest or principal than expected. Holders of Covered Bonds should consult their own tax advisors on how these rules may apply to payments they receive under the Covered Bonds.

The application of FATCA to Covered Bonds issued after 18 March 2012 (or whenever issued, in the case of Covered Bonds treated as equity for U.S. federal tax purposes) may be addressed in the relevant Final Terms or a Supplement to the Base Prospectus, as applicable.

### *1.2.6 Change of law and establishment of case law*

The Covered Bonds (exept for the ISD System Covered Bonds), the Receipts, the Coupons are governed by and shall be construed in accordance with, English law except for Condition 6.3 (Status of Covered Bonds), which is governed by, and construed in accordance with Icelandic law, in each case as in effect as at the date of this Base Prospectus. The ISD System Covered Bonds are governed by, and construed in accordance with Icelandic law. No assurance can be given as to the impact of any possible judicial decision or change to English law, Icelandic law and/or administrative practice after the date of this Base Prospectus.

### *1.2.7 No Gross-up*

Under the Terms and Conditions of the Covered Bonds, all payments in respect of the Covered Bonds will be made without deduction for or on account of withholding taxes imposed by the Republic of Iceland ("Iceland") or any political subdivision or any authority thereof or therein having power to tax unless such withholding or deduction is required by law, in which case such deduction will be made by the Issuer.

In the event that any such withholding or deduction is required by law, the Terms and Conditions require the Issuer to pay additional amounts in respect of such withholding or deduction subject to customary exceptions (see Condition 6.9 (Taxation)). If withholding or deduction arises as a r esult of one of the circumstances described in paragraphs (a) to (d) of Condition 6.9, the Issuer will not be required to pay such additional amounts and affected investors will receive interest payments net of such withholding. If, however, the Issuer is required to pay additional amounts, it will have the option under Condition 6.8.13 (Redemption for Tax Reasons) to redeem the relevant Covered Bonds early.

The last paragraph of Condition 6.9 deals with Article 3 of the Income Tax Act No. 90/2003 ("ITA") (as amended by Act No. 70/2009), which imposes withholding tax on payments of Icelandic sourced interest to foreign bondholders at a rate of 10%, unless exemptions are available to the relevant bondholders in their home countries or under a double taxation treaty with Iceland.

### *1.2.8 Existing currency restrictions – Icelandic laws and rules on foreign exchange*

On 28 N ovember 2008, the Icelandic Parliament passed Act No. 134/2008, amending the Act on F oreign Exchange No. 87/1992, as amended, (the "Foreign Exchange Act") granting the Icelandic Central Bank powers to intervene in the currency market with the view of stabilising the foreign exchange rate of the Icelandic króna. For this purpose, the Central Bank issued new Rules on Foreign Exchange, No. 1082, on 28 November 2008 (the "Foreign Exchange Rules"). The Foreign Exchange Rules in force at the date of this Base Prospectus are No. 300, of 13 April 2013.

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

The Foreign Exchange Rules were codified with the adoption of Act No. 127/2011, amending the Foreign Exchange Act whereby the provision of the Foreign Exchange Rules were effectively adopted in the Act, as a new Article 13, items a. to n. The codification included a number of minor amendments to wording.

The Foreign Exchange Act was further amended with the adoption of Acts No. 16/2013 and 35/2013 in March 2013 where the restrictions laid down in the Act were altered from being temporary provisions only. The aim is to lift the restrictions as soon as possible but no specific date has been determined. The amended Acts furthermore increased the Icelandic Central Bank's supervision authority.

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

### *1.2.9 No events of default*

The Terms and Conditions of the Covered Bonds contain no contractual events of default or right to accelerate the Covered Bonds on a failure to pay, insolvency of the Issuer or otherwise. If the Issuer fails to make a payment when due or becomes insolvent, then the Covered Bonds remain outstanding in accordance with the Terms and Conditions of the Covered Bonds.

### *1.2.10 Maintenance of the Register*

The Issuer must maintain a Register (the "Register") in respect of the Covered Bonds, the Cover Pool and any derivative agreements. If the Register or the value of the Cover Pool is not maintained in accordance with the Act, the FME may revoke the Issuer's license to issue Covered Bonds. Assets in a cover pool must be endorsed showing they are part of a cover pool and have been entered in a register as provided for in the Act on Covered Bonds. The endorsement must also indicate that the debt instrument is to secure priority rights of a specific class of covered bonds.

If the Issuer fails to enter the assets in the Cover Pool and payments received therefrom ("Cover Pool Revenue") in the Register, the Covered Bondholders and Swap Providers will not have priority claims to the Cover Pool and the Cover Pool Revenue and will rank with the Issuer's unsecured creditors in the event of the Issuer being subject to winding-up proceedings.

### *1.2.11 Conflicting interests of other creditors*

The rights of the Covered Bondholders rank junior to counterparties to derivative agreements included in the Cover Pool, though they have preferential right with respect to other creditors against the Cover Pool. Further, in the event of the winding up of the Issuer, they will rank junior to costs incurred in connection with the operation, management, collection and realisation of the Cover Pool, as well as the claims due to derivative agreements concluded in accordance with the provisions of the Act on Covered Bonds, which will be covered before the claims of the Covered Bondholders.

To the extent that Covered Bondholders are not fully paid from the proceeds of the liquidation of the assets comprising the Cover Pool, they will be able to apply for the balance of their claims as unsecured creditors of the Issuer and will be entitled to receive payment from the proceeds of the liquidation of the other assets of the Issuer not comprising the Cover Pool. The Covered Bondholders would in such case rank *pari passu* with the other unsecured, unsubordinated creditors of the Issuer and, as a result, may not receive all amounts owed by the Issuer to such Covered Bondholders. Please note that as a result of the enactment of Act No. 125/2008, on the Authority for Treasury Disbursements Due to Special Financial Market Circumstances etc., should the Issuer enter into winding-up proceedings, such claims of Covered Bondholders would be subordinated to claims of the Issuer's depositors.

### *1.2.12 Restriction on ability to petition for bankruptcy*

If distributions on realisation of the assets in the Cover Pool are insufficient to make payments on the Covered Bonds, none of the Covered Bondholders, any Swap Provider, any Paying Agent shall be entitled at any time to institute against the Issuer, or join in any institution against the Issuer of any winding up, bankruptcy, reorganisation, arrangement, insolvency or liquidation proceedings or other proceedings under any applicable bankruptcy or similar law in connection with any obligations of the Issuer relating to the issuance of the Covered Bonds, save for lodging a claim in the liquidation of the Issuer which is initiated by another party or taking proceedings to obtain a declaration or judgment as to the obligations of the Issuer in relation thereto.

### *1.2.13 Liquidity*

If the Issuer is wound up, neither the Issuer nor its estate would be authorised to issue further Covered Bonds. It would therefore not be possible for a winding-up committee to fund the estate in the market through the issuance of further Covered Bonds following the winding-up of the Issuer. Further, neither the Act on Covered Bonds nor the Rules stipulate that the winding-up committee or the Issuer's estate may contract debt obligations of any kind in order to service timely payment under the terms of the Covered Bonds. There is no legislation in effect which states that the winding-up committee managing the Issuer's estate can raise loans or enter into any such agreements in order to service the timely payment of interest and principal on the Covered Bonds. Article 17(1) of the Act on Covered Bonds states that the winding-up committee shall fulfil an issuer's commitments under covered bonds and derivative agreements using the mortgage bonds and other assets in the Cover Pool and payments received on such assets, provided that the assets are listed in the register. However, neither the Act on Covered Bonds nor the Rules provide any guidelines as to whether liquidity can be raised by selling the

Mortgage Bonds and other assets registered to the Cover Pool in the market. The Issuer is subject to liquidity requirements in its capacity as a commercial bank supervised by the FME, including a statutory requirement to maintain sufficient liquidity to enable it to discharge its obligations as they fall due. The Issuer is subject to Central Bank of Iceland's Rules no. 782/2012, on Liquidity Ratios. The FME has issued guidelines on liquidity, which are not binding on the Issuer. However, any serious or systematic deviations from such guidelines may lead to the FME determining that the Issuer's business does not fulfil the statutory soundness requirement for commercial banks and result in the FME imposing sanctions against the Issuer.

## 1.3 Risk related to the Cover Pool

### *1.3.1 Non-compliance with matching rules*

The Act on Covered Bonds contains matching rules which, *inter alia*, require that the total current value of the assets registered to the Cover Pool as collateral for a specific class of Covered Bonds must always exceed the total current value of the principal of the Covered Bonds of that same class. The Act on Covered Bonds also requires that the instalments and other payment flows accruing on assets in the Cover Pool and from derivative agreements are in such a manner that all commitments towards the Covered Bondholders and derivative agreements can be met.

A breach of the matching requirements prior to the winding up of the Issuer in the circumstances where no additional assets are available to the Issuer or the Issuer lacks the ability to acquire additional assets could cause the FME to revoke the Issuer's license to issue Covered Bonds.

If the matching requirements are breached following the winding up of the Issuer, the winding-up committee would not be permitted to add more assets to the Cover Pool. The Act on Covered Bonds does not provide any further guidance as to the consequences of a breach of the matching rules following the winding up of the Issuer.

To the extent that the Covered Bondholders are not fully paid from the proceeds of the liquidation of the assets comprising the Cover Pool, the Covered Bondholders will not be able to institute against the Issuer, or join in any institution against the Issuer of any winding-up proceedings, bankruptcy, reorganisation, arrangement, insolvency or liquidation proceedings see chapter 1.2.12 above. The explanatory memorandum for the Act on Covered Bonds provides that assets can be removed from the cover pool and replaced with same kind of assets without limitations. If assets are replaced with substitute collateral there are limitations in the Act on Covered Bonds as to how much can be replaced with such collateral. Neither the Act on Covered Bonds nor the Rules provide clear guidance in this respect. This can, however, be subject to contract.

### *1.3.2 Overcollateralisation*

The Act on Covered Bonds requires the value of the assets in the Cover Pool at all times to exceed the value of the claims against the Cover Pool. However, the Act on Covered Bonds does not require that the value of such assets exceeds the value of such claims by any specific amount. Failure to maintain sufficient assets in the Cover Pool could result in the Issuer being unable to issue further Covered Bonds or refinance existing Covered Bonds.

The Issuer intends to over-collateralise the Cover Pool at all times by at least 120 per cent. The licence from FME to issue the Covered Bonds is in addition subject to a 30 per cent. maximum over-collateralization, see chapter 7.11.

### *1.3.3 The Cover Pool consists of limited assets.*

The Cover Pool consists of loans which are secured on interests in residential property, claims which the Issuer holds, or may acquire, against Covered Bond Swap Providers and certain substitute assets. All assets in the Cover Pool must comply with the Act on Covered Bonds and the Rules. See chapter 7.3 and 7.11 for a description of the assets that can constitute the Cover Pool. At the date of this Base Prospectus, all of the properties over which mortgages are created are located in Iceland. The value of the Cover Pool may therefore decline in the event of a general downturn in the value of property in Iceland, which could adversely affect the Issuer's operating results, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

### 1.3.4 *Limited Description of the Cover Pool*

Save as stipulated in each applicable Final Terms, Covered Bondholders will not receive detailed statistics or information in relation to the assets contained or to be contained in the Issuer's Cover Pool. It is expected that the constitution of the Cover Pool may change from time to time due, for example, to the purchase or origination of further residential mortgages by the Issuer from time to time. Although an independent inspector ("Independent Inspector") appointed under the Act on Covered Bonds will monitor the Issuer's compliance with some of the requirements of the Act on Covered Bonds, the Independent Inspector's report will not be made public. A regular report on the Cover Pool will, however, be published quarterly, no later than 30 days from the end of each quarter, on the Issuer's website, www.landsbankinn.is/sertryggd-skuldabref.

### 1.3.5 *Geographic Concentration Risks / Location of the properties in the Cover Pool*

Certain geographic regions of Iceland may from time to time experience weaker regional economic conditions and housing markets or be directly or indirectly affected by natural disasters or civil disturbances. Mortgage loans in such areas will experience higher rates of loss and delinquency than mortgage loans in general.

The ability of borrowers to make payments on mortgage loans may also be affected by factors which do not necessarily affect property values, such as adverse economic conditions generally, in particular geographic areas or industries, or affecting particular segments of the borrowing community (such as borrowers relying on commission income and self-employed borrowers). Such occurrences may accordingly affect the actual rate of delinquency and loss with respect to the mortgage loans in the cover pool.

The mortgage loans underlying certain series of Covered Bonds may be concentrated in certain regions. Such concentration may present the risk considerations described above in addition to those generally present for similar securities without such concentration.

The Cover Pool consists of mortgage loans which are secured in residential property. As at the date of the Base Prospectus all of the properties over which the mortgages are created are located in Iceland. The residential properties in the Cover Pool may, however, be concentrated in certain locations in Iceland. The value of the Cover Pool may decline in the event of a general or location-specific deterioration in prices of residential properties or general deterioration or location-specific deterioration in economic conditions. This could adversely affect the Issuer's operating results, financial condition and business prospects as well as its ability to perform its obligations under the Covered Bonds.

### 1.3.6 *Appraisals*

In accordance with the Act on Covered Bonds, appraisals or valuation of the properties securing the mortgage loans may be undertaken by the Issuer, and take account of the following: (a) The selling price of a property on the day the transaction is made; or (b) an independent appraisal conducted by a licensed realtor; or (c) an acquisition offer, signed on behalf of both the seller and the buyer; or (d) the rateable value of the property, made by Registers Iceland (*Ice. "Þjóðskrá Íslands"*). Appraisals based on the selling price of a property shall be valid for a period of 3 months from the day the transaction was made.

Such appraisal undertaken by the Issuer will be verified by the Independent Inspector as being based on an accepted methodology.

No assurance can be given that values of the properties underlying the mortgage loans have remained or will remain at the levels which existed on the dates of appraisal (or, where applicable, on the dates of appraisal updates) of the related mortgage loans.

The appraisal relates both to the land and to the structure; in fact, a significant portion of the appraised value of a property may be attributable to the value of the land rather than to the residence. Because of the unique locations and special features of certain properties, identifying comparable properties in nearby locations may be difficult. The appraised values of such properties will be based to a greater extent on adjustments made by the appraisers to the appraised values of reasonably similar properties rather than on objectively verifiable sales data. As a result, such appraisals could be more likely to overvalue certain properties and therefore overstate the value of the collateral underlying the Cover Pool.

### 1.3.7 *Audit of the Cover Pool – No due diligence*

Other than any reviewed interim financial statements or audited annual financial statements the Issuer does not publish any separate review or audits of the Cover Pool. However the Issuer is subject to surveillance by an Independent Inspector in accordance with the requirements of the Act on Covered Bonds and FME; this

Independent Inspector monitors that the register is maintained in a correct manner. See chapter 7.7 for a description of the Independent Inspector.

The Issuer will not undertake any investigations, searches or other actions in respect of the assets in the Cover Pool. The Covered Bondholders will not have the ability to investigate the Cover Pool but will instead rely on the obligations of the Issuer under the Act on Covered Bonds and the supervision of the Independent Inspector.

### *1.3.8 Factors that may affect the realisable value of the Cover Pool*

The Cover Pool revenue or the realisable value of Cover Pool, in the event of the winding up of the Issuer, may be reduced, which may affect the ability of the Issuer (or the winding-up committee in the event of the winding up of the Issuer) to make payments on the Covered Bonds as a result of:

- Borrowers defaulting payments of amounts due on their mortgage loans;
- changes to the lending criteria of the Issuer;
- no representations or warranties being given by the Issuer;
- set-off risks in relation to some types of mortgage loans in the Cover Pool; and
- possible regulatory changes by regulatory authorities in Iceland.

Each of these factors is discussed in more detail below. However, it should be noted that the matching rules under the Act on Covered Bonds are intended to ensure that the value of the Cover Pool will be sufficient to enable the Issuer to meet its obligations under the Covered Bonds and any derivative agreements.

### *1.3.9 Court proceedings regarding the legal basis for the price indexation of loans*

A related issue concerns the validity of Icelandic loans indexed to the CPI. A borrower has brought legal proceedings against the Issuer claiming that CPI indexation should be found illegal based on a number of arguments, including that the increase in loan amounts is unjust and can be challenged on the basis of Article 36 of the Act on Contracts etc. Another argument is that indexation is a form of derivative and should therefore not have been offered to consumers without extensive consulting in accordance with Act on Securities Transactions, which has implemented the requirements of the MiFID.

### *1.3.10 Default by borrowers in paying amounts due on their loans.*

Borrowers may default on their obligations under the mortgage loans in the Cover Pool. Defaults may occur for a variety of reasons. The mortgage loans are affected by credit, liquidity and interest rate risks. Various factors influence mortgage delinquency rates, prepayment rates, repossession frequency and the ultimate payment of interest and principal, such as changes in the national or international economic climate, regional economic or housing conditions, changes in tax laws or other laws, interest rates, inflation, the availability of financing, yields on alternative investments, political developments and government policies. Other factors in borrowers' individual, personal or financial circumstances may affect the ability of borrowers to repay the mortgage loans. Loss of earnings, illness, divorce and other similar factors may lead to an increase in delinquencies by and bankruptcies of borrowers, and could ultimately have an adverse impact on the ability of borrowers to repay the mortgage loans. In addition, the ability of a borrower to sell a property pledged as security for a mortgage loan at a price sufficient to repay the amounts outstanding under that mortgage loan will depend upon a number of factors, including the availability of buyers for that property, the value of that property and property values in general at the time.

The Act on Covered Bonds provides that no mortgage loan may be registered in the Cover Pool if payment on it is 90 days or more in arrears.

### *1.3.11 Changes to the lending criteria of the Issuer*

Each of the mortgage loans originated by the Issuer will have been granted in accordance with its lending criteria at the time of origination. It is expected that the Issuer's lending criteria will generally consider type of property, term of loan, age of applicant, the loan-to-value ("LTV") ratio, status of applicants and credit history. The Issuer retains the right to revise its lending criteria from time to time but would do so only to the extent that such a change would be acceptable to a reasonable, prudent mortgage lender. If the lending criteria changes in a manner that affects the creditworthiness of the mortgage loans, that may lead to increased defaults by borrowers and may affect the Cover Pool revenue or the realisable value of the Cover Pool.

In accordance with the Act on Covered Bonds the Issuer may only include in the Cover Pool mortgage loans issued against mortgages secured by real property if the LTV ratio does not exceed 80% for residential property, 60% for industrial, office or commercial property, and 70% for agricultural property. Moreover, as noted above, mortgage loans 90 days or more in arrears may not be registered in the Cover Pool.

### *1.3.12 Set-off risks in relation to some types of loans may adversely affect the value of the Cover Pool or any part thereof*

Registration of assets in the Cover Pool will not affect the rights of borrowers. Borrowers will therefore continue to have independent set-off rights against the Issuer (such as, for example, set-off rights associated with borrowers' holding deposits with the Issuer).

The exercise of set-off rights by borrowers may adversely affect the realisable value of the Cover Pool and/or the ability of the winding-up committee to meet in full the Issuer's obligation under the Covered Bonds.

### *1.3.13 No representations or warranties to be given by the Issuer if Cover Pool to be sold*

In the event of the bankruptcy of the Issuer, the winding-up committee shall fulfil the Issuer's obligations under the Covered Bonds and any Swap Agreements using the assets in the Cover Pool and the Cover Pool Revenue. In respect of any sale of assets in the Cover Pool to third parties, the Issuer may not be permitted to give representations and warranties or indemnities in respect of the assets in the Cover Pool. Accordingly, there is a risk that the realisable value of the Cover Pool could be adversely affected by the lack of representations and warranties or indemnities which in turn could adversely affect the ability of the administrator to meet in full all the Issuer's obligations under the Covered Bonds.

## 1.4 Reliance on Swap Providers

A brief description of certain risks relating to swaps is set out below. The Issuer is however not permitted to enter into Currency Swaps under the Issuer's current licence to issue Covered Bonds.

### *1.4.1 Reliance on Currency Swaps*

Subject to currency restrictions in place at each time, the Issuer may rely on the Currency Swap Providers under the Currency Swaps to provide payments on Covered Bonds denominated in currencies other than ISK. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under a Currency Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Currency Swap. If the Issuer defaults under a Currency Swap due to non-payment or otherwise, the relevant Currency Swap Provider will not be obliged to make further payments under that Currency Swap and may terminate that Currency Swap. If a Currency Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Currency Swap Agreement, or if it defaults in its obligations to make payments under a Currency Swap, the Issuer will be exposed to changes in currency exchange rates and in the associated interest rates on the currencies. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

### *1.4.2 Reliance on Interest Rate Swaps*

Subject to currency restrictions in place at each time, in order to hedge the Issuer's interest rate risks in ISK and/or other currencies to the extent that these have not already been hedged by the Cover Pool Swap or a Currency Swap, the Issuer may enter into Interest Rate Swaps. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under an Interest Rate Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Interest Rate Swap. If the substitute assets available to the Issuer on a payment date are insufficient to make the payment ordinarily required in full, the payment obligations of both the Issuer and the swap counterparty on that payment date may be reduced accordingly and may be deferred should the Issuer introduce deferral of payment mechanics into the interest rate swaps. If the Issuer defaults under an Interest Rate Swap due to non-payment or otherwise, the relevant Interest Rate Swap Provider will not be obliged to make further payments under that Interest Rate Swap and may terminate that Interest Rate Swap. If an Interest Rate Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Interest Rate Swap Agreement, or if it defaults on its obligation to make payment under an Interest Rate Swap, the Issuer will be exposed to changes in interest rates. Unless a r eplacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

### *1.4.3 Reliance on Indexed Currency Swaps*

Subject to currency restrictions in place at each time, the Issuer may rely on the Indexed Currency Swap Providers under the Currency Swaps to provide payments on Covered Bonds denominated in currencies other than ISK and not pegged to an index. If the Issuer fails to make timely payment of amounts due or certain other events occur in relation to the Issuer under an Indexed Currency Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Currency Swap. If the Issuer defaults under an Index Currency Swap due to non-payment or otherwise, the relevant Indexed Currency Swap Provider will not be obliged to make further payments under that Indexed Currency Swap and may terminate that Indexed Currency Swap. If an Indexed Currency Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the relevant Indexed Currency Swap Agreement, or if it defaults in its obligations to make payments under an Indexed Currency Swap, the Issuer will be exposed to changes in currency exchange rates, the associated interest rates on the currencies and inflation. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payments due on the Covered Bonds.

### *1.4.4 Reliance on Cover Pool Swap*

In order to hedge the possible variance between the rates of interest payable on the Covered Bonds and the various rates of interest payable in respect of certain assets registered to the Cover Pool, the Issuer may enter into the Cover Pool Swap. If the Issuer fails to make timely payments of amounts due or certain other events occur in relation to the Issuer under the Cover Pool Swap and any applicable grace period has expired, then the Issuer will have defaulted under that Cover Pool Swap. If the Issuer defaults under the Cover Pool Swap due to non-payment or otherwise, the Cover Pool Swap Provider will not be obliged to make further payments under the Cover Pool Swap and may terminate the Cover Pool Swap. If the Cover Pool Swap Provider is not obliged to make payments, or if it exercises any right of termination it may have under the Cover Pool Swap Agreement, or if it defaults in its obligation to make payment under the Cover Pool Swap, the Issuer will be exposed to changes in interest rates. Unless a replacement swap is entered into, the Issuer may have insufficient funds to make payment due on the Covered Bonds.

### *1.4.5 Termination payments for Swaps*

If any of the Interest Rate Swaps, Currency Swaps or Cover Pool Swap is terminated, the Issuer may as a result be obliged to make a termination payment to the relevant Swap Provider. The amount of the termination payment will be based on the cost of entering into a replacement Interest Rate Swap, Currency Swap or Cover Pool Swap, as the case may be. Any termination payment to be made by the Issuer to a Swap Provider will rank *pari passu* with payments due to the Covered Bondholders.

### *1.4.6 Potential amendments to swap agreements*

lf and when the Issuer enters into a swap agreement in the context of an issue of Covered Bonds, the terms of the swap agreement will be negotiated with the relevant swap provider. As a result of such negotiations, the terms of a swap agreement may contain terms that adversely affect the Issuer's operating results, financial condition and business prospects and its ability to perform its obligations under the Covered Bonds.

## 1.5 Risks related to the structure of a particular issue of Covered Bonds

A wide range of Covered Bonds may be issued under the Programme. A number of these Covered Bonds may have features which contain particular risks for potential investors. Set out below is a description of the most common such features:

### *1.5.1 Covered Bonds subject to optional redemption by the Issuer*

If the optional redemption feature of the Covered Bonds is applicable in the Final Terms, it is likely to limit their market value. During any period when the Issuer may elect to redeem Covered Bonds, the market value of those Covered Bonds generally will not rise substantially above the price at which they can be redeemed. This may also be true prior to any redemption period.

The Issuer may be expected to redeem Covered Bonds when its cost of borrowing is lower than the interest rate on the Covered Bonds. At those times, an investor generally would not be able to reinvest the redemption proceeds at an effective interest rate as high as the interest rate on the Covered Bonds being redeemed and may only be able to do so at a significantly lower rate. Potential investors should consider reinvestment risk in light of other investments available at that time.

### *1.5.2 Fixed/Floating Rate Covered Bonds*

Fixed/Floating Rate Covered Bonds may bear interest at a rate that converts from a fixed rate to a floating rate, or from a floating rate to a fixed rate. Where the Issuer has the right to effect such a conversion, this will affect the secondary market and the market value of the Covered Bonds since the Issuer may be expected to convert the rate when it is likely to produce a lower overall cost of borrowing. If the Issuer converts from a fixed rate to a floating rate in such circumstances, the spread on the Fixed/Floating Rate Covered Bonds may be less favourable than the prevailing spreads on comparable Floating Rate Covered Bonds tied to the same reference rate. In addition, the new floating rate at any time may be lower than the rates on other Covered Bonds. If the Issuer converts from a floating rate to a fixed rate in such circumstances, the fixed rate may be lower than then prevailing rates on its Covered Bonds.

### *1.5.3 Covered Bonds issued at a substantial discount or premium*

The market values of securities issued at a substantial discount or premium from their principal amount tend to fluctuate more in relation to general changes in interest rates than do prices for conventional interest-bearing securities. Generally, the longer the remaining term of the securities, the greater the price volatility as compared to conventional interest-bearing securities with comparable maturities.

### *1.5.4 Extendable obligations under the Covered Bonds*

Following the failure by the Issuer to pay the Final Redemption Amount of a Series of Covered Bonds on their Maturity Date, payment of such amounts shall be automatically deferred. This will occur if the Final Terms for a relevant Series of Covered Bonds provides that such Covered Bonds are subject to an extended maturity date on which the payment of all or (as applicable) part of the Final Redemption Amount payable on the Maturity Date will be deferred in the event that the Final Redemption Amount is not paid in full on the Maturity Date (the "Extended Maturity Date").

To the extent that the Issuer has sufficient funds available to pay in part the relevant Final Redemption Amount in respect of the relevant Series of Covered Bonds, the Issuer shall make partial payment of the relevant Final Redemption Amount as described in Condition 6.8.12 f). Payment of all unpaid amounts shall be deferred automatically until the applicable Extended Maturity Date, provided that any amount representing the Final Redemption Amount due and remaining unpaid on the Maturity Date may be paid by the Issuer on any Interest Payment Date thereafter up to (and including) the relevant Extended Maturity Date.

The Issuer is not required to notify the Covered Bondholders of such automatic deferral. The Extended Maturity Date and the applicable interest rate will be specified in the relevant Final Terms. Interest will continue to accrue on any unpaid amount and be payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date. In these circumstances, failure by the Issuer to make payment in respect of the Final Redemption Amount on the Maturity Date shall not constitute a default in payment by the Issuer. However, failure by the Issuer to pay the Final Redemption Amount or the balance thereof on the Extended Final Maturity Date and/or interest on such amount on any Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date shall constitute a default in payment by the Issuer.

Furthermore, in relation to all amounts constituting accrued interest due and payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date, as provided in the applicable Final Terms, the Issuer may pay such interest pursuant to the Floating Rate set out in the applicable Final Terms notwithstanding that the relevant Covered Bond was a Fixed Rate Covered Bond as at its relevant Issue Date.

In addition, following deferral of the Maturity Date, the Interest Payment Dates and Interest Periods may change as set out in the applicable Final Terms.

## 1.6 Risks related to Covered Bonds generally

Set out below is a brief description of certain risks relating to the Covered Bonds generally:

### *1.6.1 The Covered Bonds may not be a suitable investment for all investors*

Each potential investor in the Covered Bonds must determine the suitability of that investment in light of its own circumstances. In particular, each potential investor should:

- have sufficient knowledge and experience to make a meaningful evaluation of the Covered Bonds, the merits and risks of investing in the Covered Bonds and the information contained or incorporated by reference in this Base Prospectus or any applicable supplement;
- have access to, and knowledge of, appropriate analytical tools to evaluate, in the context of its particular financial situation, an investment in the Covered Bonds and the impact the Covered Bonds will have on its overall investment portfolio;
- have sufficient financial resources and liquidity to bear all of the risks of an investment in the Covered Bonds, including Covered Bonds with principal or interest payable in one or more currencies, or where the currency for principal or interest payments is different from the potential investor's currency;
- understand thoroughly the terms of the Covered Bonds and be familiar with the behaviour of any relevant indices and financial markets; and
- be able to evaluate (either alone or with the help of a financial adviser) possible scenarios for legislative, economic, interest rate and other factors that may affect its investment and its ability to bear the applicable risks.

The Covered Bonds are complex financial instruments. Institutional investors generally do not purchase complex financial instruments as stand-alone investments. They purchase complex financial instruments as a way to reduce risk or enhance yield with an understood, measured, appropriate addition of risk to their overall portfolios. A potential investor should not invest in Covered Bonds which are complex financial instruments unless it has the expertise (either alone or with a financial adviser) to evaluate how the Covered Bonds will perform under changing conditions, the resulting effects on the value of the Covered Bonds and the impact this investment will have on the potential investor's overall investment portfolio.

### *1.6.2 Covered Bonds are obligations of the Issuer only*

The Covered Bonds will constitute obligations of the Issuer only and have the benefit of a statutory preference under the Act on Covered Bonds on the Cover Pool maintained by the Issuer. An investment in the Covered Bonds involves a reliance on the creditworthiness of the Issuer. The Covered Bonds are not guaranteed by any other person.

In addition, an investment in the Covered Bonds involves the risk that subsequent changes in the actual or perceived creditworthiness of the Issuer may adversely affect the market value of the relevant Covered Bonds. There can be no assurance that the Cover Pool will be sufficient to pay in full the amounts payable under the Covered Bonds.

### *1.6.3 Covered Bonds issued under the Programme*

Covered Bonds issued under the Programme (save in respect of the first issue of Covered Bonds) will either be fungible with an existing Series of Covered Bonds or have different terms to an existing Series of Covered Bonds (in which case they will constitute a new Series). All Covered Bonds issued from time to time will rank *pari passu* with each other in all respects and will rank *pari passu* with any other Covered Bonds which may be issued by the Issuer in accordance with the Act on Covered Bonds.

### *1.6.4 EU Savings Directive*

Under EC Council Directive 2003/48/EC, on the taxation of savings income, member states are required to provide to the tax authorities of another Member State details of interest payments (or similar income) paid by a person within its jurisdiction to an individual resident in that other Member State or to certain limited types of entities established in that other Member State. However, for a transitional period, Luxembourg and Austria are instead required (unless during that period they elect otherwise) to operate a withholding system in relation to such payments (the ending of such transitional period being dependent upon the conclusion of certain other agreements relating to information exchange with certain other countries). A number of non-EU countries and territories including Switzerland have adopted similar measures (a withholding system in the case of Switzerland).

The European Commission has proposed certain amendments to Directive 2003/48/EC which may, if implemented, amend or broaden the scope of the requirements described above.

If a payment were to be made or collected through a Member State which has opted for a withholding system and an amount of, or in respect of, tax were to be withheld from that payment, neither the Issuer nor any Paying Agent nor any other person would be obliged to pay additional amounts with respect to any Covered Bond as a result of the imposition of such withholding tax. The Issuer is required to maintain a Paying Agent in a Member State that is not obliged to withhold or deduct tax pursuant to the Directive.

### *1.6.5 Change of law*

The Covered Bonds (except for the ISD System Covered Bonds), the Receipts, the Coupons are governed by and shall be construed with, English law except for Condition 6.3 (Status of Covered Bonds), which is governed by, and construed in accordance with Icelandic law, in each case as in effect as at the date of this Base Prospectus. The ISD System Covered Bonds are governed by, and construed in accordance with Icelandic law. No assurance can be given as to the impact of any possible judicial decision or change to English law, Icelandic law and/or administrative practice after the date of this Base Prospectus.

### *1.6.6 Covered Bonds where denominations involve integral multiples: definitive Covered Bonds*

In relation to any issue of Covered Bonds which have denominations consisting of a minimum Specified Denomination plus one or more higher integral multiples of another smaller amount, it is possible that such Covered Bonds may be traded in amounts that are not integral multiples of such minimum Specified Denomination. In such a case a holder who, as a result of trading such amounts, holds an amount which is less than the minimum Specified Denomination in his account with the relevant clearing system at the relevant time may not receive a definitive Covered Bond in respect of such holding (should definitive Covered Bonds be printed) and, in order to receive a d efinitive Covered Bond, would need to purchase a principal amount of Covered Bonds such that its holding amounts to a Specified Denomination.

If definitive Covered Bonds are issued, holders should be aware that definitive Covered Bonds which have a denomination that is not an integral multiple of the minimum Specified Denomination may be illiquid and difficult to trade.

### *1.6.7 Reliance on Euroclear and Clearstream, Luxembourg procedures*

Covered Bonds (other than the ISD System Covered Bonds) issued under the Programme will be represented on issue by one or more Global Covered Bonds that may be deposited with a common depositary (in the case of Bearer Covered Bonds) or common safekeeper (in the case of registered Global Covered Bonds) for Euroclear and Clearstream, Luxembourg (each as defined under Condition 6.2, "Form of the Covered Bonds"). Except in the circumstances described in each Global Covered Bond, investors will not be entitled to receive Covered Bonds in definitive form. Each of Euroclear and Clearstream, Luxembourg and their respective direct and indirect participants will maintain records of the beneficial interests in each Global Covered Bond held through it. While the Covered Bonds (other than the VS System Covered Bonds) are represented by Global Covered Bonds, investors will be able to trade their beneficial interests only through the relevant clearing systems and their respective participants.

While the Covered Bonds (other than the ISD System Covered Bonds) are represented by Global Covered Bonds, the Issuer will discharge its payment obligation under the Covered Bonds by making payments through the relevant clearing systems. A holder of a beneficial interest in Global Covered Bonds must rely on the procedures of the relevant clearing system and its participants to receive payments under the Covered Bonds. The Issuer has no responsibility or liability for the records relating to, or payments made in respect of, beneficial interests in any Global Covered Bond.

Holders of beneficial interests in a Global Covered Bonds will not have a direct right to vote in respect of the Covered Bonds so represented. Instead, such holders will be permitted to act only to the extent that they are enabled by the relevant clearing system and its participants to appoint appropriate proxies.

## 1.7 Risks related to the market generally

Set out below is a brief description of the principal market risks, including liquidity risk, exchange rate risk, interest rate risk and credit risk:

### *1.7.1 The secondary market generally*

Covered Bonds may have no established trading market when issued, and one may never develop. If a market does develop, it may not be very liquid. Additionally, the market places concerned may be closed, or temporary restrictions may be imposed. Therefore, investors may not be able to sell their Covered Bonds easily or at prices that will provide them with a yield comparable to similar investments that have a developed secondary market. This is particularly the case for Covered Bonds that are especially sensitive to interest rate, currency or market risks, are designed for specific investment objectives or strategies or have been structured to meet the investment requirements of limited categories of investors. These types of Covered Bonds generally would have a more limited secondary market and more price volatility than conventional debt securities.

### *1.7.2 Lack of liquidity in the secondary market may adversely affect the market value of the Covered Bonds*

Generally weak global credit market conditions could contribute to a lack of liquidity in the secondary market for instruments similar to the Covered Bonds. In addition, the difficult market conditions which have prevailed since mid-September 2008 have limited the primary market for a number of financial products including instruments such as the Covered Bonds. While some measures have been taken by governments, there can be no assurance that the market for securities similar to the Covered Bonds will recover at the same time or to the same degree as such other recovering global credit market sectors. Any of these fluctuations may be significant and could result in significant losses to an investor.

### *1.7.3 Exchange rate risks and exchange controls*

The Issuer will pay principal and interest on the Covered Bonds in the Specified Currency, subject to currency restrictions in place at each time, if the Covered Bonds are issued in currencies other than ISK. This presents certain risks relating to currency conversions if an investor's financial activities are denominated principally in a currency or currency unit (the "Investor's Currency") other than the Specified Currency. These include the risk that exchange rates may significantly change (including changes due to devaluation of the Specified Currency or revaluation of the Investor's Currency) and the risk that authorities with jurisdiction over the Investor's Currency may impose or modify exchange controls. An appreciation in the value of the Investor's Currency relative to the Specified Currency would decrease (1) the Investor's Currency-equivalent yield on the Covered Bonds, (2) the Investor's Currency-equivalent value of the principal payable on the Covered Bonds and (3) the Investor's Currency-equivalent market value of the Covered Bonds.

Government and monetary authorities may impose (as some have done in the past) exchange controls that could adversely affect an applicable exchange rate. As a result, investors may receive less interest or principal than expected, or no interest or principal.

Exchange rate risk is mitigated by the use of the Currency Swaps and by matching interest rate flow with the maturity of loan and other assets of the Issuer.

### *1.7.4 Interest rate risks*

Interest rate risks occur when fixed interest periods or interest basis for assets and liabilities do not coincide. Investment in Fixed Rate Covered Bonds involves the risk that subsequent changes in market interest rates may adversely affect the value of the Fixed Rate Covered Bonds. Investments in Floating Rate Covered Bonds will involve a risk of interest rate changes.

The Issuer may enter into the Cover Pool Swap and Interest Rate Swaps to ensure that the risks do not exceed the limit values approved by its Board of Directors and to ensure that matching is maintained in accordance with the Act on Covered Bonds.

### *1.7.5 Trading in the clearing systems*

In relation to any issue of Covered Bonds which have a minimum denomination and are tradable in the clearing systems in amounts above such minimum denomination, should definitive Covered Bonds be required to be issued, a holder who does not have an integral multiple of the minimum denomination in his account with the relevant clearing system at the relevant time may not receive all of his entitlement in the form of definitive Covered Bonds unless and until such time as his holding becomes an integral multiple of the minimum denomination.

### *1.7.6 Judicial considerations may restrict certain investments*

The investment activities of certain investors are subject to rules and regulations and/or review or regulation by certain authorities. Each potential investor should consult his legal advisers or responsible supervisory authority in order to determine whether and to what extent the investor has the opportunity to invest in Covered Bonds.

### *1.7.7 Credit ratings may not reflect all risks*

One or more independent credit rating agencies may assign credit ratings to the Covered Bonds. The ratings may not reflect the potential impact of all risks related to structure, market, additional factors discussed above, and other factors that may affect the value of the Covered Bonds. A credit rating is not a recommendation to buy, sell or hold securities and may be revised or withdrawn by the rating agency at any time. A credit rating may not reflect all risks associated with an investment in the Covered Bonds.

In general, European regulated investors are restricted under Regulation (EC) No. 1060/2009 (as amended) (the "CRA Regulation") from using credit ratings for regulatory purposes, unless such ratings are issued by a credit rating agency established in the EU and registered under the CRA Regulation (and such registration has not been withdrawn or suspended), subject to transitional provisions that apply in certain circumstances whilst the registration application is pending. Such general restriction will also apply in the case of credit ratings issued by non-EU credit rating agencies, unless the relevant credit ratings are endorsed by an EU-registered credit rating agency or the relevant non-EU rating agency is certified in accordance with the CRA Regulation (and such endorsement action or certification, as the case may be, has not been withdrawn or suspended). The list of registered and certified rating agencies published by the European Securities and Markets Authority ("ESMA") on its website in accordance with the CRA Regulation is not conclusive evidence of the status of the relevant rating agency included in such list, as there may be delays between certain supervisory measures being taken against a relevant rating agency and the publication of the updated ESMA list. Certain information with respect to the credit rating agencies and ratings will be disclosed in the Final Terms.

### *1.7.8 Legal investment considerations may restrict certain investments*

The investment activities of certain investors are subject to investment laws and regulations, or review or regulation by certain authorities. Each potential investor should consult its legal advisors to determine whether and to what extent (1) Covered Bonds are legal investments for it, (2) Covered Bonds can be used as collateral for various types of borrowing and (3) other restrictions apply to its purchase or pledge of any Covered Bonds. Financial institutions should consult their legal advisors or the appropriate regulators to determine the appropriate treatment of Covered Bonds under any applicable risk-based capital or similar rules.

## 1.8 Risk Management

### *1.8.1 Risk management structure*

The Board of Directors of the Issuer has overall responsibility for the establishment and oversight of the Issuer's risk management framework and for defining risk appetite. The Issuer's CEO is responsible for the effective implementation of the framework and risk appetite through the Issuer's corporate governance structure and committees. The Issuer's CEO has established and is a member of the Issuer's Credit Committee, Risk and Finance Committee, and the Executive Management Committee.

The Credit Committee deals with credit risk, both credit limits for individual customers as well as credit risk policy issues, while the Risk and Finance Committee covers primarily market risk, liquidity risk and legal risk. The Risk and Finance Committee monitors all the Issuer's risks, is responsible for enforcing the Issuer's risk appetite and risk limits and reviews and approves changes to risk models prior to submission to the Board of Directors. The Executive Management Committee serves as a f orum for consultation and communication between the Issuer's 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 Issuer's Risk Management Division is responsible for the functioning of the Issuer's risk management framework. Subsidiaries of the Issuer have their own risk management functions, but the Risk Management Division receives information on exposures from the subsidiaries and collates them.

The Risk Management Division has five departments:

The Credit Management Department 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 as further described in chapter 1.8.2.2 below. Secondary voting on decisions exceeding the authorisation of the Risk Management Division is referred to the Issuer's Credit Committee.

The Credit Risk Monitoring Department is responsible for monitoring credit risk within the Issuer's credit portfolio. This is done by operating a credit monitoring system. The Credit Risk Monitoring Department is also responsible for the portfolio valuation methodology as well as for the operation of the Issuer's write-off process. In addition the Department works with other departments on impairment analysis.

The Market Risk Department is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the banking book for the Issuer. The Issuer's banking book is the portfolio of assets, primarily loans the Issuer expects to hold until maturity when the loan is repaid fully; the banking book typically refers to the loans the Issuer underwrites. The Market Risk Department is also responsible for monitoring all derivatives trading the Issuer enters into, both for hedging and trading purposes. Market risk monitoring also includes FX balance monitoring for the Issuer as well as providing limit monitoring for pension funds under management by the Issuer. The Market Risk Department is also responsible for comprehensive risk reporting to various departments and committees.

The Operational Risk Department is responsible for ensuring that the Issuer's operational risks are monitored and that the Issuer implements and maintains an effective operational risk management framework.

The Models and Analysis Department is responsible for providing, developing and maintaining the Issuer'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 Issuer. In addition, the Department is responsible for credit risk, economic capital and risk appetite reporting within the Issuer, as well as reporting to supervisory authorities.

The Issuer's Compliance Department ensures that the Issuer adheres to its own rules on securities trading and insider trading and that the Issuer's operations comply with the Act on Securities Transactions, Act on Actions to Combat Money Laundering and Terrorist Financing, and other relevant legislation and regulations. The Compliance Department also monitors the Issuer's adherence to codes of ethics and focuses on limiting market abuse, minimising conflicts of interest and ensuring best practice.

Internal Audit is part of the Issuer'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 Issuer. The effectiveness of the Issuer's risk management and risk assessment procedures, including the Internal Capital Adequacy Assessment Process ("ICAAP"), is evaluated by Internal Audit and the findings are reported to the Issuer's Board of Directors. The activities of Internal Audit extend to every operating unit, including the Issuer's subsidiaries.

#### *1.8.1.1 Risk appetite*

Risk appetite within the Issuer is defined as the level and nature of risk that the Issuer is willing to take in order to pursue its business objectives. In 2012, the Issuer's risk appetite was reviewed, revised and implemented for 2013. The Risk appetite is reviewed and revised at least annually.

#### *1.8.1.2 Risk management process*

Risk is inherent in the Issuer's activities and is managed through a process of on-going 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 Issuer's operations and undertakings. Risk measurement entails measuring the identified risks for management and monitoring purposes. Finally, risk controls and limits ensure compliance with rules and procedures and ensure compliance with the Issuer's risk appetite.

The objective of the Issuer'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 the risk appetite adopted by the Issuer, and will comply with regulatory requirements. In order to ensure that the fluctuations, which might affect the Issuer's equity as well as performance, are kept limited and manageable, the Issuer has adopted several policies regarding the risk structure of its portfolio.

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

The material risks which the Issuer is exposed to and arise from financial instruments are credit risk, market risk and liquidity risk. The Issuer is also exposed to other relevant risks, such as operational risk. These risk factors are further discussed in chapter 1.1.

### *1.8.2 Credit Risk*

#### *1.8.2.1 Credit risk assessment*

Credit risk is measured in three main dimensions: Probability of default ("PD"), loss given default ("LGD") and exposure. For the purpose of measuring PD the Issuer has developed an internal rating system, including a number of internally developed rating models. The objectives of the rating system are to provide a meaningful assessment of obligor characteristics; a meaningful differentiation of credit quality; and accurate and consistent quantitative estimates of default risk, i.e. probabilities of default. Internal ratings and associated PD play an essential role in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an "obligor rating scale" which reflects exclusively quantification of the risk of obligor default, i.e. credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors going from 1 to 10, where 10 indicates the highest credit quality, and the grade 0 for defaulted obligors. The rating assignment is supported by rating models, which take information such as industry classification, financial accounts and payment behaviour into account.

The rating assignment and approval is an integrated part of the credit approval process and assignment shall be updated at least annually or when material information on the obligor or exposure becomes available, whichever is earlier.

LGD is measured using the models defined in the Basel Framework for the purpose of Economic Capital calculations. In addition, during 2012 the Issuer implemented in the business processes an internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the aforementioned Basel model.

Exposure is calculated using the credit conversion factors of the Basel framework.

#### *1.8.2.2 Credit risk control and monitoring*

The Issuer monitors exposures to identify signs of weakness in customer operations affecting their earnings and liquidity at the earliest possible time. To monitor customers the Issuer uses, supplemental to ratings, a credit monitoring classification of four credit risk groups (green, yellow, orange and red). The colour classification used is the following:

- Green customers are considered performing without difficulties.
- Yellow customers are on *Watch list 1*. They have temporary difficulties and may need some instalments postponed or modification to terms or loan covenants.
- Orange customers are on *Watch list 2*. They are still under the supervision of the relevant business unit but are likely to go through debt restructuring or postponement of instalments.
- Red customers are under the supervision of the Corporate Solutions Department and need restructuring, write-offs or a debt-to-equity conversion. Management of the customer's operations will possibly be taken over by the Issuer. In some cases, collateral or guarantees will be collected and/or the operations sold.

The Credit Risk Monitoring Department within Risk Management is together with the business units responsible for the verification of colour for the customer and the transferral of customers from the business units to Corporate Solutions if necessary.

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

The Issuer 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.

#### *1.8.2.3 Credit risk management*

The Issuer's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk and Finance Committee, the Credit Committee, the credit units within Risk Management and the business units. The Issuer 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 Issuer's internal framework of regulation and guidelines. The CEO monitors together with the Issuer's managers that the Issuer'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 confirmation by Credit Management within Risk Management. Credit decisions exceeding the limits of Credit Management are subject to approval by the Issuer's Credit Committee. Credit decisions exceeding the limits of the Credit Committee are subject to approval by the Board of Directors, which has the highest credit authorization within the Issuer.

### *1.8.2.4 Credit risk mitigation*

Mitigating risks in the credit portfolio is a key element of the Issuer's credit policy, as well as an inherent part of the credit decision process. Securing loans with collateral is the main method of mitigating credit risk whereas for many loan products, collateral is required by legislations in the mortgage finance market, or is standard market practice.

The most important types of collateral are real property and financial assets (shares or bonds).

The Issuer regularly assesses the market value of pledged collateral. The Issuer has developed models to estimate the value of the most common types of collateral. In case of collateral for which no valuation model exists, the Issuer calculates the value manually 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 listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability.

The Issuer monitors the market value of mark to market collaterals and may require additional collateral in accordance with underlying loan agreements.

### *1.8.2.5 Derivative financial instruments*

In order to mitigate credit risk arising from derivatives, the Issuer 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 Issuer also enters into standard International Swaps and Derivatives Association ("ISDA") master agreements with financial institutions and similar general agreements with other derivatives counterparties of the Issuer. Such agreements include, among other things, netting and set-off arrangements.

The Issuer makes appropriate collateral and margin requirements for all derivative contracts the Issuer enters into. Collateral management and monitoring is performed daily and derivative contracts with clients are usually fully hedged.

The Issuer's supervision system monitors derivative exposure and collateral value intraday, issues margin calls and manages netting agreements.

### *1.8.2.6 Loan impairment*

The Issuer's policy requires that individual financial assets above materiality thresholds be reviewed at least quarterly, and more frequently when circumstances require. 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 as profit or loss. The impact of financial restructuring of the Issuer's customers is reflected in loan impairment, or net adjustments to loans and advances, as the expected cash flow of customers has changed.

The Issuer has significantly reduced granting loans in foreign currency unless the customer's income is in the same currency or a comparable currency.

### *1.8.2.7 Maximum exposure to credit risk*

The following tables show the Issuer's maximum credit risk exposure at 30 June 2013. 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 Issuer might have to pay for guarantees, loan commitments in their full amount, and undrawn overdraft and credit card facilities.

**Table 1.1: Maximun exposure to credit risk and concentration by industry sectors (ISK million)**

| At 30 June 2013 | Financial institutions | Public entities* | Individuals | Corporations: Fisheries | Construction and real estate companies | Services | Retail | Holding companies | Manu-facturing | Agri-culture | ITC** | Other | Carrying amount |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 0 | 23.643 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 23.643 |
| Bonds and debt instruments | 865 | 244.861 | 0 | 0 | 19.722 | 0 | 0 | 9.173 | 0 | 0 | 0 | 3.765 | 278.386 |
| Derivative instruments | 96 | 0 | 2 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 26 | 124 |
| Loans and advances to financial institutions | 70.671 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 70.671 |
| Loans and advances to customers | 0 | 11.074 | 192.740 | 133.694 | 117.262 | 42.839 | 39.613 | 68.736 | 25.039 | 11.828 | 19.347 | 3.239 | 665.411 |
| Other financial assets | 6.335 | 285 | 695 | 21 | 1.410 | 851 | 10 | 0 | 4 | 13 | 2 | 74 | 9.700 |
| Total on-balance sheet exposure | 77.967 | 279.863 | 193.437 | 133.715 | 138.394 | 43.690 | 39.623 | 77.909 | 25.043 | 11.841 | 19.349 | 7.104 | 1.047.935 |
| Off-balance sheet exposure | 3.352 | 16.271 | 24.659 | 11.313 | 20.308 | 14.269 | 9.798 | 913 | 2.942 | 1.610 | 2.934 | 654 | 109.023 |
| Financial guarantees and underwriting commitments | 0 | 155 | 522 | 1.398 | 4.142 | 5.716 | 1.018 | 34 | 871 | 39 | 742 | 43 | 14.680 |
| Undrawn loan commitments | 600 | 9.829 | 0 | 7.966 | 14.426 | 232 | 3.769 | 38 | 418 | 1.236 | 899 | 431 | 39.844 |
| Undrawn overdraft/credit card facilities | 2.752 | 6.287 | 24.137 | 1.949 | 1.740 | 8.321 | 5.011 | 841 | 1.653 | 335 | 1.293 | 180 | 54.499 |
| Maximum exposure to credit risk | 81.319 | 296.134 | 218.096 | 145.028 | 158.702 | 57.959 | 49.421 | 78.822 | 27.985 | 13.451 | 22.283 | 7.758 | 1.156.958 |
| Percentage of carrying amount | 7,0% | 25,6% | 18,9% | 12,5% | 13,7% | 5,0% | 4,3% | 6,8% | 2,4% | 1,2% | 1,9% | 0,7% | 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.

### *1.8.2.8 Colleteral types*

The following tables shows the colleterals used to mitigate credit risk.

**Table 1.2: Collateral types (ISK million)**

| At 30 June 2013 | Real Estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1.650 | 0 | 28 | 0 | 89 | 1.767 |
| Individuals | 125.952 | 204 | 1.006 | 2.390 | 11.643 | 141.195 |
| Corporates | | | | | | |
| Fisheries | 6.922 | 117.858 | 181 | 6.807 | 13.760 | 145.528 |
| Construction and real estate companies | 78.998 | 201 | 1.083 | 372 | 2.021 | 82.675 |
| Holding companies | 5.333 | 0 | 175 | 35.926 | 5.586 | 47.020 |
| Retail | 11.028 | 8 | 315 | 1.501 | 13.231 | 26.083 |
| Services | 17.352 | 675 | 394 | 1.332 | 6.451 | 26.204 |
| ITC | 315 | 0 | 38 | 1.704 | 5.984 | 8.041 |
| Manufacturing | 8.120 | 273 | 300 | 5.813 | 2.955 | 17.461 |
| Agriculture | 3.890 | 15 | 6 | 0 | 2.774 | 6.685 |
| Other | 3 | 0 | 0 | 0 | 1 | 4 |
| Total | 259.563 | 119.234 | 3.526 | 55.845 | 64.495 | 502.663 |

### *1.8.2.9 Loans and advances*

The following tables show the credit quality, measured by rating grade, of loans and advances neither past due nor individually impaired.

**Table 1.3: Loans and advances neither past due nor individually impaired (ISK million)**

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| At 30 June 2013 | 10-7 | 6-4 | 3-1 | 0* | Unrated | Total |
| Financial institutions | 64.209 | 6.462 | 0 | 0 | 0 | 70.671 |
| Public entities | 6.351 | 771 | 10 | 0 | 18 | 7.150 |
| Individuals | 6.674 | 106.680 | 24.733 | 495 | 4.705 | 143.287 |
| Corporations | | | | | | |
| Fisheries | 8.251 | 46.880 | 16.460 | 905 | 0 | 72.496 |
| Construction and real estate companies | 0 | 62.079 | 30.581 | 162 | 22 | 92.844 |
| Holding companies | 0 | 23.946 | 24.706 | 6 | 26 | 48.684 |
| Retail | 0 | 13.397 | 17.262 | 420 | 34 | 31.113 |
| Services | 713 | 21.645 | 7.953 | 55 | 261 | 30.627 |
| Information, technology and communication | 12 | 13.231 | 647 | 1 | 0 | 13.891 |
| Manufacturing | 0 | 16.271 | 2.126 | 114 | 375 | 18.886 |
| Agriculture | 215 | 3.451 | 948 | 4 | 7 | 4.625 |
| Other | 0 | 1.926 | 265 | 0 | 1.124 | 3.315 |
| Total | 86.425 | 316.739 | 125.691 | 2.162 | 6.572 | 537.589 |

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.

**Table 1.4: Loans and advances past due but not individually impaired (ISK million)**

| At 30 June 2013 | Past due 1-5 days | Past due 6-30 days | Past due 31 - 60 days | Past due 61 - 90 days | Past due over 90 days | Gross carrying amount |
|---|---|---|---|---|---|---|
| Public entities | 0 | 259 | 0 | 0 | 35 | 294 |
| Individuals | 4.111 | 10.530 | 3.552 | 1.930 | 8.807 | 28.930 |
| Corporations | 4.950 | 5.703 | 7.827 | 2.000 | 21.829 | 42.309 |
| Total | 9.061 | 16.492 | 11.379 | 3.930 | 30.671 | 71.533 |

### *1.8.2.10 Large exposures*

At 30 June 2013, two of the Issuer’s clients were rated as large exposures. Clients are rated as large exposures if their total obligations, or those of financially or administratively connected parties, exceed 10% of the Issuer’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 Issuer’s large exposures were within these limits as at 30 June 2013

At 30 June 2013, no exposure exceeded 20%. According to the Issuer’s risk appetite, the total utilisation percentage of a large exposure ought to remain below 50% of the Issuer’s capital base.

**Table 1.5: Large exposures (ISK million)**

| At 30 June 2013 | Number of large exposures | Large exposures |
|---|---|---|
| Large exposures between 10% and 20% of the Group’s capital base | 2 | 67.095 |
| Total | 2 | 67.095 |

## *1.8.3 Liquidity risk management*

A liquidity policy for the Issuer and its subsidiaries is in place and is 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 policy is built on a framework published in Basel III standards on liquidity risk measurement. The Issuer has performed monthly reports on new liquidity measurements set forward in the framework in 2012 a nd will continue implementation of those measurements in 2013.

The Issuer follows liquidity rules set by the Central Bank of Iceland to govern the ratio of weighted liquid assets and liabilities, as well as guidelines No. 1/2008 of FME on best practice for managing liquidity in a banking organisation. 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 Issuer has been within the the limits of the stress test for the period covered by the historical financial information in the Base Prospectus. The guidelines set by the FME require the ratio of core liquid assets to deposits to stay above 20% and the ratio of cash and cash equivalents to on-demand deposits to stay above 5%. The Issuer has implemented a r isk appetite where these rules and guidelines as well as inner requirements within the Issuer, set benchmarks for liquidity management.

The Issuer’s liquidity risk is managed centrally by Treasury and monitored by Market Risk. This allows management to monitor and manage liquidity risk throughout the Issuer. The Risk and Finance Committee monitors the Issuer’s liquidity risk, while the Issuer’s Internal Audit assesses whether the liquidity management process is designed properly and operating effectively.

The Issuer 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 less than 12 months. The Issuer has neither defaulted on any principal or interest nor breached any material covenants in respect of liabilities.

The Issuer’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 financing counterparties 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 a liquidity crisis.

The Market Risk Department conducts weekly stress tests by applying various hypothetical scenarios on the Issuer’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 Issuer’s deposit base.

The key measure used by the Issuer for monitoring liquidity risk is the ratio of core liquid assets to deposits, which shows the ratio of deposits that the Issuer 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 the Central Bank, loans to financial institutions (maturity within seven days) and assets eligible for repo transactions with the Central Bank (such as government bonds).

### *1.8.3.1 Deposit stickiness*

Stickiness is a method that the Issuer uses to estimate the stability of the deposit base. The Bank of International Settlements (“BIS”) defines stickiness as tendency of funding not to run off quickly under stress. The Issuer has categorised its deposit base into seven different groups representing different levels of stickiness. The groups are based on Basel III’s Liquidity Coverage Ratio (“LCR”) methodology and are reflected in the Issuer’s internal liquidity stress tests where a concentration charge is applied to account for possible outflows.

### *1.8.3.2 Maturity analysis of financial instruments*

The following table shows a maturity analysis of the Issuer’s financial instruments as at 30 June 2013.

**Table 1.6: Maturity analysis of fincancial asstes and liabilities (ISK million)**

| **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 | 23.643 | 0 | 0 | 0 | 0 | 23.643 | 23.643 |
| Bonds and debt instruments | 0 | 57.633 | 43.506 | 57.662 | 197.514 | 356.315 | 278.386 |
| Loans and advances to financial institutions | 0 | 63.223 | 5.736 | 1.713 | 0 | 70.672 | 70.671 |
| Loans and advances to customers | 20.606 | 76.726 | 97.369 | 368.330 | 386.876 | 949.907 | 665.411 |
| Other financial assets | 0 | 9.144 | 0 | 556 | 0 | 9.700 | 9.700 |
| Total | 44.249 | 206.726 | 146.611 | 428.261 | 584.390 | 1.410.237 | 1.047.811 |
| | | | | | | | |
| **Derivative financial assets** | | | | | | | |
| Gross settled derivatives | | | | | | | 96 |
| Inflow | 0 | 33.588 | 931 | 0 | 0 | 34.519 | |
| Outflow | 0 | -33.496 | -934 | 0 | 0 | -34.430 | |
| Total | 0 | 92 | -3 | 0 | 0 | 89 | 96 |
| **Net settled derivatives** | 0 | 28 | 0 | 0 | 0 | 28 | 28 |
| Total | 0 | 120 | -3 | 0 | 0 | 117 | 124 |
| | | | | | | | |
| **Non-derivative financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | -101.356 | -8.670 | 0 | 0 | 0 | -110.026 | -110.025 |
| Deposits from customers | -313.059 | -70.442 | -40.233 | -24.930 | -5.466 | -454.130 | -448.931 |
| Short positions | 0 | -6.336 | 0 | 0 | 0 | -6.336 | -6.317 |
| Secured bonds | 0 | -150 | -14.997 | -276.366 | -37.054 | -328.567 | -297.459 |
| Contingent bond | 0 | -13.045 | 0 | 0 | 0 | -13.045 | -13.045 |
| Other financial liabilities | -414.415 | -98.643 | -55.230 | -301.296 | -42.520 | -912.104 | -875.777 |
| Total | | | | | | | |
| | | | | | | | |
| **Off-balance sheet items** | -12 | -1.570 | -2.305 | -2.124 | -8.669 | -14.680 | |
| Financial guarantees and underwriting commitments | -39.844 | 0 | 0 | 0 | 0 | -39.844 | |
| Undrawn loan commitments | -54.499 | 0 | 0 | 0 | 0 | -54.499 | |
| Debt underwriting commitments | -94.355 | -1.570 | -2.305 | -2.124 | -8.669 | -109.023 | |
| Undrawn overdraft/credit card commitments | | | | | | | |
| Total | -508.770 | -100.213 | -57.535 | -303.420 | -51.189 | -1.021.127 | -875.777 |
| | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet items** | | | | | | | |
| | | | | | | | -663 |
| **Derivative financial liabilities** | 0 | 24.645 | 0 | 1.098 | 0 | 25.743 | |
| **Gross settled derivatives** | 0 | -24.692 | 0 | -1.431 | 0 | -26.123 | |
| Inflow | 0 | -47 | 0 | -333 | 0 | -380 | -663 |
| Outflow | 0 | -64 | 0 | - | 0 | -64 | -64 |
| Total | 0 | -111 | 0 | -333 | 0 | -444 | -727 |
| **Net settled derivatives** | | | | | | | |
| Total | -464.521 | 106.522 | 89.073 | 124.508 | 533.201 | 388.783 | 171.431 |
| | | | | | | | |
| **Net liquidity position** | **-433.929** | **54.987** | **90.739** | **137.276** | **480.219** | **329.292** | **154.436** |

### 1.8.4 *Market risk management*

Market risk arises from imbalances in the Issuer's balance sheet in terms of interest rates and indexation as well as the risks related to the Issuer's exposure in bonds, equities, open currency positions and derivatives both arising from proprietary position-taking as well as the Issuer's market-making functions.

The Board of Directors is responsible for determining the Issuer's overall risk appetite, including market risk. The CEO appoints the Risk and Finance Committee, which is responsible for developing detailed market risk management policies and setting market risk limits. Treasury and the Market Making Department within Markets are responsible for managing market-related positions under the supervision of Market Risk. Treasury manages the Issuer's market risk in accordance with the guidelines set by the Risk and Finance Committee. The market risk associated with the Issuer's responsibilities as a market maker and short positions in various market traded bonds and equity is limited to certain limits set by the Risk and Finance committee and monitored by the Market Risk Department within Risk Management. The objective of the Market Risk Department is to identify, locate and monitor market risk exposures, and to analyse and report 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 Issuer's market risk is thereby measured and monitored on a daily basis, and Market Risk monitors the limits set in the Issuer's risk appetite and submits these and other market risk measurements to the Risk and Finance Committee every other week. Several indicators are used, including daily profits and losses as well as net positions across different attributes such as the currency and issuer.

#### 1.8.4.1 *Interest rate risk*

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

The following tables summarise the Issuer'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. The amounts presented are categorised by the earlier of either the contractual repricing or the maturity date.

**Table 1.7: Interest rate risk (ISK million)**

| At 30 June 2013 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 23.643 | 0 | 0 | 0 | 23.643 |
| Bonds and debt instruments | 216.782 | 37.232 | 2.992 | 21.380 | 278.386 |
| Derivative instruments | 124 | 0 | 0 | 0 | 124 |
| Loans and advances to financial institutions | 63.222 | 5.736 | 1.713 | 0 | 70.671 |
| Loans and advances to customers | 459.874 | 63.851 | 74.780 | 66.906 | 665.411 |
| Other financial assets | 9.144 | 0 | 556 | 0 | 9.700 |
| Total | 772.789 | 106.819 | 80.041 | 88.286 | 1.047.935 |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | -110.025 | 0 | 0 | 0 | -110.025 |
| Deposits from customers | -441.624 | -6.684 | -623 | 0 | -448.931 |
| Derivative instruments and short positions | -728 | -3.948 | -2.280 | -88 | -7.044 |
| Secured bonds | -296.295 | 0 | -1.164 | 0 | -297.459 |
| Contingent bond | 0 | 0 | 0 | 0 | 0 |
| Other financial liabilities | -13.045 | 0 | 0 | 0 | -13.045 |
| Total | -861.717 | -10.632 | -4.067 | -88 | -876.504 |
| | | | | | |
| Net on-balance sheet position | -88.928 | 96.187 | 75.974 | 88.198 | 171.431 |
| Net off-balance sheet position | 560 | 0 | -560 | 0 | |
| | | | | | |
| **Total interest repricing gap** | -88.368 | 96.187 | 75.414 | 88.198 | |

#### 1.8.4.2 *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.

### *1.8.4.3 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 Issuer employs a quarterly stress test of the interest rate risk in the Issuer's overall non-trading net on-balance sheet position. In this test, the interest rate curve is shifted for every currency. The Issuer has been within the limits of the stress test for the period covered by the historical financial information in the Base Prospectus.

### *1.8.4.4 CPI indexation risk (all portfolios)*

To mitigate the Issuer's imbalance in its CPI-indexed assets and liabilities, which the Issuer is in a limited position to do, the Issuer offers non-CPI indexed loans and CPI-indexed deposits. CPI indexation risk is managed centrally within the Issuer by the Treasury of the Issuer, and is monitored by Market Risk.

Management of the Issuer's CPI indexation risk is supplemented by monitoring the sensitivity of the Issuer's overall position in CPI-indexed financial assets and liabilities net on-balance sheet to various inflation/deflation scenarios.

CPI indexation risk is managed centrally within the Issuer by the Treasury of the Bank, and is monitored by Market Risk. At 30 June 2013 the CPI imbalance, calculated as the difference between CPI-indexed financial assets.

**Table 1.8: CPI indexation risk (ISK million)**

| As at 30 June 2013 | Carrying amount |
|---|---|
| **Assets** | |
| Bonds and debt instruments | 25.553 |
| Loans and advances to customers | 250.218 |
| Total | 275.771 |
| | |
| **Liabilities** | |
| Due to financial institutions and Central Bank | (16) |
| Deposits from customers | (100.992) |
| Total | (101.008) |
| | |
| Total on-balance sheet position | 174.762 |
| Total off-balance sheet position | (1.295) |
| | |
| **Total CPI indexation balance** | **173.467** |

### *1.8.4.5 Currency risk (all portfolios)*

The Issuer follows the Rules 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 15% of the Bank's Capital base, in each currency and for all currencies combined. The Bank submits daily and monthly reports to the Central Bank with information on its foreign exchange balance.

The Issuer's combined net foreign exchange balance as at 30 June was 2.28% of the Issuer's Capital base. Uncertainty regarding the denomination currencies of the Issuer's loan portfolio has not been fully resolved.

**Table 1.9: Concentration of currency risk (ISK million)**

| At 30 June 2013 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 640 | 195 | 277 | 11 | 52 | 355 | 1.530 |
| Bonds and debt instruments | 15.471 | 45.157 | 52.779 | 0 | 0 | 0 | 113.407 |
| Equities and equity instruments | 12.314 | 244 | 1 | 0 | 0 | 4.907 | 17.466 |
| Derivative instruments | 91 | 4 | 1 | 0 | 0 | 0 | 96 |
| Loans and advances to financial institutions | 33.352 | 9.349 | 14.825 | 2.176 | 71 | 3.037 | 62.810 |
| Loans and advances to customers | 90.369 | 18.086 | 55.902 | 8.404 | 9.307 | 6.728 | 188.796 |
| Other assets | 2 | 0 | 87 | 0 | 0 | 22 | 111 |
| Total | 152.239 | 73.035 | 123.872 | 10.591 | 9.430 | 15.049 | 384.216 |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | -7.681 | -3.798 | -5.563 | 0 | -139 | -706 | -17.887 |
| Deposits from customers | -23.078 | -4.780 | -25.305 | -1.709 | -969 | -6.811 | -62.652 |
| Derivative instruments and short positions | -180 | -10 | -473 | 0 | 0 | 0 | -663 |
| Secured bonds | -147.464 | -54.965 | -93.866 | 0 | 0 | 0 | -296.295 |
| Other liabilities | -1.190 | -412 | -631 | -18 | -10 | -520 | -2.781 |
| Total | -179.593 | -63.965 | -125.838 | -1.727 | -1.118 | -8.037 | -380.278 |
| | | | | | | | |
| Net on-balance sheet position | -27.354 | 9.070 | -1.966 | 8.864 | 8.312 | 7.012 | 3.938 |
| Net off-balance sheet position | 33.891 | -11.794 | 5.677 | -8.135 | -7.612 | -10.821 | 1.206 |
| | | | | | | | |
| **Net currency position** | **6.537** | **-2.724** | **3.711** | **729** | **700** | **-3.809** | **5.144** |
| **Net currency position of capital base** | 2,90% | -1,21% | 1,64% | 0,32% | 0,31% | -1,69% | 2,28% |

### *1.8.5 Operational risk management*

Whereas the 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 Issuer establishes, maintains and coordinates 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 Issuer ensures that operational risk management stays consistent throughout the Issuer 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 Issuer intends to ensure that all of the Issuer'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.

### *1.8.6 Capital management*

The Issuer's capital management policies and practices ensure that the Issuer has sufficient capital to cover the risk associated with its activities. The capital management framework of the Issuer comprises four interdependent activities: Capital Assessment, Risk Appetite/Capital Target, Capital Planning, and Reporting/Monitoring. The Issuer 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 Issuer is willing to take in pursuit of its business objectives.

Capital requirements are defined by two external bodies: the European Council and the FME. The basis of the requirements of both bodies is the EU Capital Requirements Directive ("CRD"). The regulatory minimum capital requirement under Pillar I of the CRD is 8% of risk-weighted assets for credit risk, market risk and operational risk. The Capital Adequacy Requirement ("CAR") is reviewed by the FME in the Supervisory Review and Evaluation Process ("SREP").

The Issuer uses the standardised approach in measuring Pillar I risks. RWA for credit risk, the single largest risk type, amounted to 77.3% of total RWA. The Internal Capital Adequacy Assessment Process ("ICAAP") under Pillar II is the Issuer's calculation of its solvency need (as percentage of RWA) and is based on economic capital calculations, stress tests and result of the Supervisory Review and Evaluation Process ("SREP"). The Economic Capital is estimated at 15.5% for year-end 2012. In the latest SREP process, based on year-end 2011, the FME determined the CAR ratio to be at 19.5%, mainly because of uncertainty regarding currency loans. This is 11.5% additional to the requirement of the CRD.

The Issuer's equity at 30 June 2013 amounted to ISK 229.830 million, equivalent to 20.4% of total assets. The capital adequacy ratio, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 25.9% at 30 June 2013. Under the Act the minimum requirement for this ratio is 8%.

The FME requires the Issuer to maintain a minimum core Tier 1 capital ratio of 12% unless revised by FME. The previous CAR requirement of the FME for the Issuer was increased from 16% to 19.5% in the fourth quarter of 2012 (estimation based on year-end 2011) and is now determined by the Issuer's calculation of its solvency need (ICAAP report) and SREP by the FME which is performed each year.

### *1.8.6.1 Internal Capital Assessment*

The Issuer views its internal capital need as the amount of capital required to ensure that it stays solvent with a predefined confidence level and time horizon. For this purpose, an Economic Capital Framework has been developed and implemented. Economic Capital ("EC") is a common risk measure, which is applied to all material risks. It captures unexpected losses and reduction in value or income for which the Issuer needs to hold capital to avoid insolvency. It arises from the unexpected nature of losses as distinct from expected losses. EC is defined as the difference between unexpected losses and expected losses, where unexpected loss is defined as the 99.9% Value-at-Risk, with a one year time horizon.

**Table 1.10: Economic Capital (ISK million)**

| As at 31 March 2013 | |
|---|---|
| Credit risk | 66.615 |
| Credit risk - Other assets | 4.935 |
| Market risk | 5.415 |
| Currency risk | 3.309 |
| Operational risk | 8.111 |
| Creditor concentration risk | 7.412 |
| Industry concentration risk | 2.192 |
| Interest rate risk | 10.399 |
| Business risk | 4.056 |
| Legal and regulatory risk | 15.122 |
| Total | 127.565 |
| EC/RWA | 14,90% |

Minimum internal capital requirements are defined as the higher of the regulatory capital requirement and Economic Capital. The minimum capital requirements according to Basel II Pillar 1 / EU Capital Requirements Directive ("CRD") is 8%.

Furthermore, as part of the Issuer's stress-testing process, the Issuer assesses a minimum internal capital buffer, which equals the amount of capital that is needed to ensure that the Issuer stays above the minimum capital requirement during normal fluctuations in the business environment, such as a mild recession, and in the risks taken on. The minimum internal capital buffer is intended to have a countercyclical behaviour.

# 2 NOTICE TO INVESTORS

This Base Prospectus, dated 3 October 2013, constitutes a base prospectus for the purposes of Article 5 of Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 ("the Prospectus Directive") and Article 45 of the Act on Securities Transactions and relevant regulations thereto.

This Base Prospectus and copies of Final Terms relating to the Covered Bonds which are admitted to trading on a regulated market will be available on the website of the Issuer, www.landsbankinn.is (http://www.landsbankinn.is/sertryggd-skuldabref).

This Base Prospectus has been prepared to provide clear and thorough information on the Issuer. Investors are encouraged to acquaint themselves thoroughly with this Base Prospectus. They are advised to pay particular attention to chapter 1 on Risk Factors. This Base Prospectus should by no means be viewed or construed as a promise by the Issuer or other parties of future success either in operations or return on investments. Investors are reminded that investing in securities entails risk, as the decision to invest is based on expectations and not promises. Investors must rely primarily on their own judgement regarding any decision to invest in the Issuer's securities, bearing in mind, inter alia, the business environment in which it operates, anticipated profits, external conditions and the risk inherent in the investment itself. Prospective investors are advised to contact experts, such as licensed financial institutions, to assist them in their assessment of the securities issued by the Issuer as an investment option. Investors are advised to consider their legal status, including taxation issues that may concern the purchase or sale of the Issuer's securities and seek external and independent advice in that respect.

Neither this Base Prospectus nor any other information supplied in connection with the Programme or any Covered Bonds (i) is intended to provide the basis of any credit or other evaluation or (ii) should be considered as a recommendation by the Issuer that any recipient of this Base Prospectus or any other information supplied in connection with the Programme or any Covered Bonds should purchase any Covered Bonds. Each investor contemplating purchasing any Covered Bonds should make its own independent investigation of the financial condition and affairs, and its own appraisal of the creditworthiness of the Issuer. Neither the Base Prospectus nor any other information supplied in connection with the Programme or the issue of any Covered Bonds constitutes an offer or invitation by or on behalf of the Issuer to any person to subscribe for or to purchase any Covered Bonds.

This Base Prospectus does not constitute an offer to sell or the solicitation of an offer to buy any Covered Bonds in any jurisdiction to any person to whom it is unlawful to make the offer or solicitation in such jurisdiction. The distribution of this Base Prospectus and the offer or sale of Covered Bonds may be restricted by law in certain jurisdictions. The Issuer does not represent that this Base Prospectus may be lawfully distributed, or that any Covered Bonds may be lawfully offered, in compliance with any applicable registration or other requirements in any such jurisdiction, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. In particular, no action has been taken by the Issuer which would permit a public offering of any Covered Bonds or distribution of this Base Prospectus in any jurisdiction where action for that purpose is required. Accordingly, no Covered Bonds may be offered or sold, directly or indirectly, and neither this Base Prospectus nor any advertisement or other offering material may be distributed or published in any jurisdiction, except under circumstances that will result in compliance with any applicable laws and regulations. Persons into whose possession this Base Prospectus or any Covered Bonds may come must inform themselves about, and observe any such restrictions on the distribution of this Base Prospectus and the offering and sale of Covered Bonds. The Issuer accepts no liability to any person in relation to the distribution of this Base Prospectus in any jurisdiction. In particular, there are restrictions on the distribution of this Base Prospectus and the offer or sale of Covered Bonds in the United States, the European Economic Area and Japan.

This Base Prospectus may be passported in accordance with the provisions of the Prospectus Directive into other jurisdictions within the European Economic Area.

No person is or has been authorised by the Issuer to give any information or to make any representation of information not contained in or not consistent with this Base Prospectus or any other information supplied in connection with the Programme or the Covered Bonds and, if given or made, such information or representation must not be relied upon as having been authorised by the Issuer.

Neither the delivery of this Base Prospectus nor the offering, sale or delivery of any Covered Bonds shall in any circumstances imply that the information contained herein concerning the Issuer is correct at any time subsequent to the date hereof or that any other information supplied in connection with the Programme is correct as of any time subsequent to the date indicated in the document containing the same.

The language of this Base Prospectus is English. Certain legislative references and technical terms have been cited in their original language in order that the correct technical meaning may be ascribed to them under the applicable law. Capitalised terms used in this Base Prospectus have been defined in chapter 6 in the section of the Terms and Conditions entitled "Definitions", in chapter 2.5.1 or throughout this Base Prospectus.

## 2.1 Issuer's statement

The Board of Directors and CEO of Landsbankinn hf., Reg. No. 471008-0280, registered office at Austurstræti 11, 155 Reykjavík, Iceland., on behalf of the Issuer hereby declare that, having taken all reasonable care to ensure that such is the case, the information contained in this Base Prospectus is, to the best of their knowledge, in accordance with the facts and contains no omission likely to affect its import.

Reykjavík, 3 October 2013

On behalf of the Board of Directors,

Tryggvi Pálsson,

Chairman of the Board of Directors

On behalf of Landsbankinn hf.,

Steinþór Pálsson,

Chief Executive Officer

## 2.2 Statutory auditor

The National Audit Office, Skúlagata 57, 105 Reykjavík, Iceland, has been the Issuer's statutory auditor for the period covered by the historical information in this Base Prospectus. The National Audit Office is authorized to outsource part of its assignments and has outsourced the audit of Landsbankinn hf. to KPMG ehf., registered office at Borgartún 27, 105 Reykjavík, Iceland for the period covered by the historical information in this Base Prospectus. The Issuer's statutory auditor has not resigned, been removed or not re-appointed during the period covered by the historical financial information in this Base Prospectus. Helgi F. Arnarson and Sigríður Helga Sveinsdóttir were the auditors on behalf of KPMG ehf. for the period covered by the historical information in this Base Prospectus. They are members of the Institute of State Authorized Public Accountants in Iceland.

## 2.3 Auditor's statement

We have audited the consolidated financial statements of Landsbankinn hf. for the years ending 31 December 2011 and 2012. In our opinion, the aforementioned consolidated financial statements give a true and fair view of the consolidated financial position of Landsbankinn hf. at 31 December 2011 and 2012 and of its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards, as adopted by the European Union.

We have reviewed the consolidated financial statements of Landsbankinn hf. for the period 1 January to 30 June 2013. Based on our review, nothing has come to our attention that causes us to believe that the condensed consolidated interim financial information is not prepared, in all material respects, in accordance with IAS 34 "*Interim Financial Reporting*", as adopted by the European Union.

Reykjavík, 3 October 2013

On behalf of KPMG ehf.

Helgi F. Arnarson, State Authorized Public Accountant

Sigríður Helga Sveinsdóttir, State Authorized Public Accountant

## 2.4 Third party information

Information in this Base Prospectus is not based on the statements of external specialists or third party other than publicly available information published by governmental entities. In such instances the information has been accurately reproduced and as far as the Issuer is aware and is able to ascertain, no facts have been omitted which would render the reproduced information inaccurate or misleading.

## 2.5 Documents on display

The following documents are available for viewing on the Issuer's website, www.landsbankinn.is (www.landsbankinn.is/sertryggd-skuldabref):

- This Base Prospectus, dated 3 October 2013.
- All issued Final Terms.
- The Issuer's Articles of Association.
- The Consolidated Financial Statements of the Issuer for the years 2011 and 2012 and the Condensed Consolidated Interim Financial Statements for six months ended 30 June 2013. The aforementioned Financial Statements can be found in chapter 9 of this Base Prospectus.

This Base Prospectus is valid until no more of the Covered Bonds concerned are issued under continued or repeated manner.

Following the publication of this Base Prospectus one or more supplements may be prepared by the Issuer and approved by the FME in accordance with Article 16 of the Prospectus Directive and Article 46 of the Act on Securities Transactions. Statements contained in any such supplements (or contained in any document incorporated by reference therein) shall, to the extent applicable (whether expressly, by implication or otherwise), be deemed to modify or supersede statements contained in this Base Prospectus. Any statement so modified or superseded shall not, except as so modified or superseded, constitute a part of this Base Prospectus.

In the event of any significant factor arising or any material mistake or accuracy relating to the information included in this Base Prospectus which is capable of affecting the assessment of any Covered Bonds or any change in the condition of the Issuer which is material in the context of the Programme or the issue of Covered Bonds, the Issuer will prepare and publish a supplement to this Base Prospectus or publish a new prospectus for use in connection with any subsequent issue of Covered Bonds.

### *2.5.1 Abbrevations and definitions*

| | |
|---|---|
| Act on Actions to Combat Money Laundering | Act no. 64/2006 on Actions to Combat Money Laundering |
| ALM | Asset and Liability Management |
| ATM | Automated Teller Machine |
| Bankruptcy Act | Bankruptcy Act No. 21/1991 |
| Base Prospectus | This Base Propectus dated [date] and issued by Landsbankinn. |
| Basel Committee | The Basel Committee on Banking Supervision |

| | |
|---|---|
| Basel III | Amendments to the Basel Committee's Framework on bank capital adequacy, stress testing and market liquidity risk. |
| BIS | Bank of International Settlements |
| CA | Current account |
| Capacent | Capacent ehf., Reg. No. 550910-0630, Borgartún 27, 105 Reykjavík, Iceland. |
| CAR | Capital Adequacy Requirement |
| Central Bank | The Central Bank of Iceland |
| CEO | Chief Executive Officer |
| Cover Pool Revenue | Assets in the Cover Pool and payments received therefrom |
| CRA Regulation | Regulation (EC) No. 1060/2009 (as amended) |
| CRD | EU Capital Requirements Directive |
| CSR | Corporate Social Responsibility |
| DMB | Deposit Money Bank |
| DoS | Denial of Service |
| EC | Economic Capital |
| EEA | European Economic Area |
| EFTA | European Free Trade Association; the International free trade organization of Iceland, Norway, Switzerland and Lichtenstein |
| Emergency Act | Act No. 125/2008, on the Authority for Treasury Disbursements Due to Special Financial Market Circumstances etc. |
| ESMA | The European Securities and Markets Authority |
| FATCA | The U.S. Foreign Account Tax Compliance Act |
| FFI | A foreign financial institution ("FFI") as defined in FATCA |
| Foreign Exchange Act | The Act on Foreign Exchange No. 87/1992 |
| Foreign Exchange Rules | The Central Bank's Rules on Foreign Exchange, No. 1082 |
| Framework | A revised framework of the Basel Committee's Capital Accord published in June 2006; "International Convergence of Capital Measurements and Capital Standards: A Revised Framework (Comprehensive Version)" |
| FX | Foreign exchange |
| GDP | Gross domestic product |
| GNI | Gross national income |
| HFF | Icelandic Housing Financing Fund |
| HR | Human resources |
| ICAAP | Internal Capital Adequacy Assessment Process |
| Ice | Icelandic |
| Iceland | Republic of Iceland |
| IMF | International Monetary Fund |

| | |
|---|---|
| Independent Inspector | Independent inspector as provided for in Chapter VIII of the Act on Covered Bonds |
| IRS | The U.S. Internal Revenue Service |
| IT | Information Technology |
| ITA | The Income Tax Act No. 90/2003 |
| LBI hf. | LBI hf., formerly Landsbanki Íslands hf., Reg. No. 540291-2259, Álfheimar 74, 104 Reykjavík Iceland. |
| LCR | Liquidity Coverage Ratio |
| LGD | Loss given default |
| LTV | Loan-to-value |
| OECD | Organisation for Economic Co-operation and Development |
| PD | Probability of Default |
| PPP | Purchasing power parity |
| RWA | Risk-Weighted Assets |
| SREP | Supervisory Review and Evaluation Process |
| SME | Small and medium sized enterprises |
| Strategic PMO | Strategic Project Management Office |
| UCITS | Undertakings for Collective Investments in Transferable Securities |
| VaR | Value at risk |
| Q | Quarter |

# 3 DESCRIPTION OF THE ISSUER

## 3.1 General information

Landsbankinn hf., Reg. No. 471008-0280, Austurstræti 11, 155 Reykjavík, Iceland (the “Issuer”, the “Bank” and “Landsbankinn”) is a leading Icelandic financial institution with total assets of ISK 1,126 billion at the end of June 2013. Landsbankinn offers a full range of financial services and is the market leader in the Icelandic financial service sector with the largest branch network, counting 34 branches and outlets. Landsbankinn was established on 7 October 2008 as a limited liability company, but the history of its predecessor, LBI hf., dates back to 1886.

Landsbankinn operates pursuant to the provisions of the Act on Financial Undertakings, No. 161/2002, the Act on Public Limited Companies, No. 2/1995 and the Act on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc., No. 125/2008. Landsbankinn is supervised by the FME.

Landsbankinn’s registered office is located at Austurstræti 11, 155 Reykjavík, Iceland, telephone: +354 410 4000.

Historical financial information in this Base Prospectus is for the period 1.1.2011to 31.3.2013. Consolidated Financial Statements of the Issuer for the years 2011 and 2012 and for the first three months of 2013 are provided in chapter 9 of this Base Prospectus.

No material adverse changes in the prospects of the Issuer have occured since the date of its last published audited financial statements on 31 December 2012.

No significant changes in the financial or trading position of the Issuer have occurred since the end of the last financial period on 30 June 2013.

## 3.2 Shareholders

The Issuer’s total share capital is 24.000.000.000 Icelandic krónur (ISK). Each share is of the nominal value of one Icelandic króna (ISK) and entitles the owner to one vote at shareholders’ meetings.

The Issuer has 1,394 shareholders. The largest shareholder is the Icelandic State Financial Investments, which manages 23,500,000,000 (97.9%) shares and voting rights of the National Treasury. The second largest shareholder is the Issuer, which holds 378,676,667 (1.58%) of its own shares. 1,392 other shareholders hold 121,323,333 (0.51%) shares and voting rights of the Issuer. The Issuer’s holding of own shares is a result of a settlement agreement, described below, between the Issuer, LBI hf. and the Icelandic State dated 15 December 2009. The settlement agreement stipulated that 500,000,000 shares be distributed to the Issuer’s employees. Delivery of the first part of the shares took place 30 September 2013 and delivery of the rest of the shares will take place in January 2014. The Issuer will hold 313,387,381 (1.31%) of its own shares after the delivery of shares in January 2014, because of retained shares to meet income taxes, financial services tax and other salary related expenses as described below, other things remaining constant.

Under the terms of the agreement, LBI hf. was to allocate from the estate and thereby from the assets of claim holders, 500,000,000 shares (2.08% of total shares) in the Issuer, in accordance with allocation rules to be determined by the bank no later than at year-end 2012. A shareholders' meeting of the Issuer, held on 17 July 2013, approved rules on the allocation of shares to employees. In allocating shares to employees, the Issuer fulfils the requirements provided for in the financial settlement with LBI hf. and imposed on it by the Icelandic State.

The allocation of shares is governed by the Issuer’s Remuneration Policy and based on FME Rules No. 700/2011, on the Salary Incentive Systems of Financial Undertakings, despite such allocation not falling under the scope of the Rules. Employees of control units will not receive shares but the bank is required by FME's Rules to ensure that these employees receive equal remuneration through other channels. It should be noted that no decision has been made to establish an incentive programme for the future.

The shares were allocated to those employees of the Issuer hf. and Landsbréf hf. (the Issuer’s subsidiary) who held permanent positions on 31 March 2013 and employees who had retired because of age, disability or terminated due to cost-cutting measures during that time. The number of shares allocated to individual employees was relative to salary and the duration of employment at Landsbankinn during the period from 15 December 2009 to 31 March 2013.

The tax value of the shares is ISK 4.7 billion. Employees are required to pay income tax on the value of the shares as on normal salary payments. The issuer retains shares in the amount of the income tax payment required from employees, financial services tax levied on financial undertakings and other salary-linked expenses and pays this amount, around ISK 2.3 billion, to the State. Around ISK 600 million will be paid to pension funds and as a result, employees will receive shares, valued for taxation purposes, at ISK 1.8 billion. This amount is divided between 1,392 current and former employees.

Upon reception of the shares, recipients oblige themselves to retain them for three years following allocation. If the bank's shares are listed on the stock exchange, 60% of the shares may be sold one month following listing. The remaining shares (40%) may not be sold until three years have elapsed from allocation. During that time, the shares may not be mortgages or assigned. Recipients of the shares must comply with these stringent requirements.

To the extent known to the Issuer, the Issuer is not directly or indirectly owned or controlled by others than those listed above.

The Issuer does not know of any arrangements, the operation of which may at a subsequent date result in a change in control of the Issuer other than discussed above.

## 3.3 Organisational structure

The Issuer is the parent company of a group and its principal subsidiaries include the following:

| Principal subsidiaries | Principal area of activity | Ownership interest |
|---|---|---|
| Eignarhaldsfélag Landsbankans ehf. | Holding company | 100% |
| Horn Fjárfestingarfélag ehf. | Investment company | 100% |
| Landsbréf ehf. | Fund management company | 100% |
| Hömlur ehf. | Holding company for appropriated assets | 100% |

## 3.4 Historical background

LBI hf. was established by the Icelandic parliament on 1 July 1886. In establishing the bank, the Icelandic parliament hoped to boost monetary transactions and encourage the country's nascent industries. The bank's first decades of operation were restricted by its limited financial capacity and it was little more than a building society.

Following the turn of the 20th century, however, Icelandic society progressed and prospered as industrialisation finally made inroads, and the bank grew and developed in parallel to the nation. In the 1920s, Landsbanki Íslands became Iceland's largest bank, and was made responsible for issuing its bank notes. After the issuing of bank notes was transferred to the then newly established Central Bank of Iceland in 1961, Landsbanki Íslands continued to develop as a commercial bank, expanding its branch network in the ensuing decades.

Liberalisation of financial services in Iceland, beginning in 1986, opened up new opportunities, which the bank managed to take advantage of, despite some economic adversity. In 1997, Landsbanki Íslands was incorporated as a limited liability company, and the ensuing privatisation was concluded in 2003. From 2003-2008 Landsbanki Íslands operated as a private bank with substantial international activities in addition to its traditional Icelandic operations.

Following the continuous deterioration of the financial markets, the FME took control of Landsbanki Íslands on 7 October 2008. Subsequently, Landsbankinn hf. was established (initially named: New Landsbanki Íslands hf., following first name change: NBI hf. and follwoing second name change: Landsbankinn hf.), around the domestic deposits and assets relating to domestic operations of Landsbanki Íslands hf. All liabilities and assets not transferred to Landsbankinn were retained in Landsbanki Íslands hf. (LBI hf.) and a resolution committee appointed to supersede the board of directors.

## 3.5 Strategy

The identifier of Landsbankinn's strategy is "Landsbankinn – your financial partner". The Bank's strategy, was introduced in 2010, rests on four main pillars, all of equal importance. These pillars are:

- A unified team, referring to the Bank's human resources and employees' positive attitude;
- A solid infrastructure, referring to procedures, financial strength, risk management and operational discipline;

- Satisfied customers, referring to the Bank's service to customers and the mutual benefit of a long-term business relationship; and, last but not least,
- Benefits to society and owners, which refers to the Bank's role in Icelandic society.

The watchwords of the Bank's strategy are listen, learn and serve. They reflect the significant change in emphasis currently being implemented in the Bank's operations. Strong emphasis is placed on listening to the customer and the community, to learn from experience and on the fact that the Bank is first and foremost a service company.

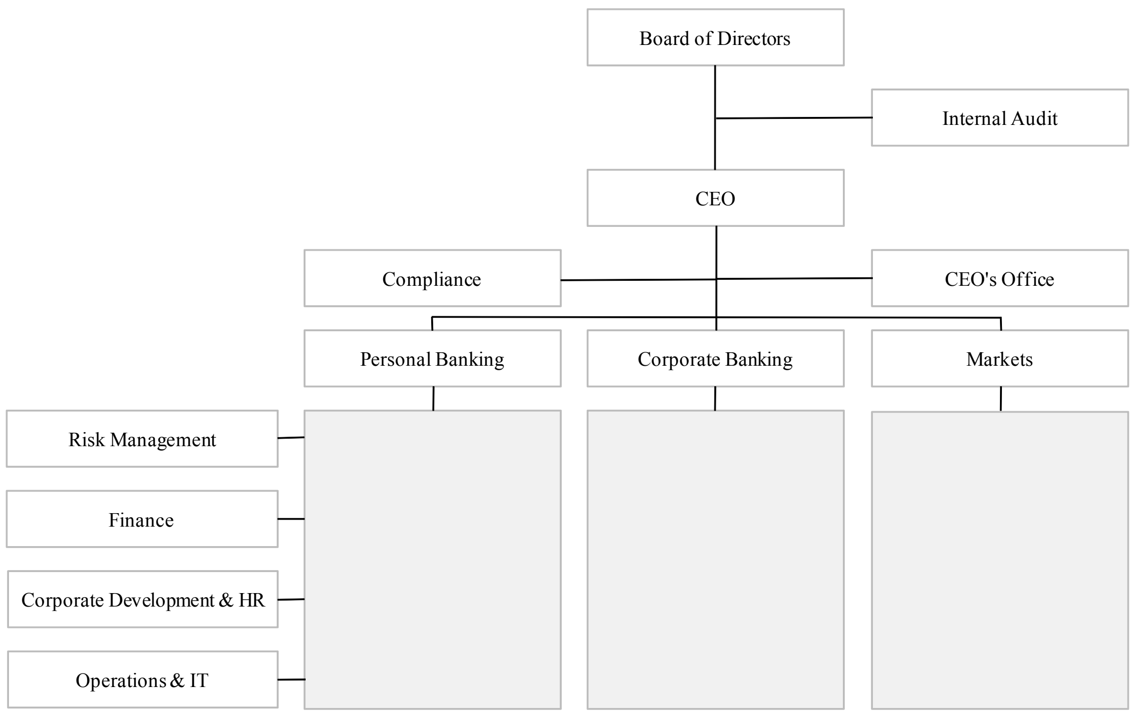
The strategy outlines the Bank's vision to become an exemplary company and to be among the best banks in the Nordic region by 2015. To achieve these goals, the focus is set on efficient operations, sound management, a unified team and a responsible marketing strategy. The Bank wants to be a force for change with the aim of creating value for customers, society, owners and employees.

In September 2012, Landsbankinn introduced new emphases leading up to 2015 based on its strategy introduced in 2010. The new emphases entail increasing operational efficiency by reducing cost, strengthening management and team unity, while also pursuing a responsible market strategy. At the same time, the Bank made significant changes to its organisational chart, which came into effect on 1 October 2012.

The changes are a natural part of the vision formed by the Bank in 2010. The Bank has achieved its key goals presented in 2010 and with these changes, emphasis is placed on increased cooperation between all of the Bank's divisions that communicate with customers, in order to offer better and more effective services for the mutual benefit of customers and the Bank in mind. The aim is to promote the objective of efficient and profitable operations while simultaneously strenghtening the branches and providing employees with a greater mandate to act.

## 3.6 Business

*Organisational Chart*




### *3.6.1 Income divisions*

The Bank has three income divisions, Personal Banking, Corporate Banking and Markets.

#### 3.6.1.1 *Personal Banking*

Personal Banking is comprised of three departments, Branch Network, Customer Service Centre and Leasing (Vehicle- and Equipment Financing). Personal Banking has two support units, the Debt Management Advisory Centre and Business Solutions.

Personal Banking provides individuals and SMEs with general as well as specialised banking services and is focused on providing a diverse product offering to its customers. At each branch, personal advisory services are on offer as well as various self-service options. In most branches SME services are also provided. Furthermore, customers are able to enjoy accessible financial services through the Customer Service Centre and the Bank's online banking. In Leifsstöð, Iceland's International airport, travellers can access a wide range of services. Personal Banking also provides financing of vehicles, equipment and machinery through the operation of the Leasing Department.

Over 100,000 individuals and around 10,000 SMEs do business with the Bank. Its market share is around 33% with respect to retail customers and 36% with respect to SMEs, according to a survey conducted by Capacent in February/March 2013.

The Bank operates 34 branches and outlets around the country. The Bank's channels of distribution and touching points with customers are in constant development and the Bank's strategy is to ensure the provision of personal, economical and value-added banking services to its customers.

#### 3.6.1.2 *Corporate Banking*

The customers of Corporate Banking are companies and municipalities and larger financing projects. Corporate Banking holds a strong position among the largest companies and institutions in Iceland. All customers of Corporate Banking are appointed a Customer Relations Manager, who is responsible for customer relations and acts as the customers' liaison with the Bank. A Relations Manager in Corporate Banking is designated to support those who are involved in credit decisions in dealing with the business of small and medium sized companies, which have their primary relations with the Bank's branch network.

Corporate Banking is comprised of four business units and three support units. The business units are split based on sector segmentation; one unit manages relations with contractors, real estate companies, travel service companies and municipalities; the second unit manages relations with industrial companies and companies in trade and service and the third manages relations with the Bank's larger customers in fisheries and agriculture. The fourth unit, Corporate Solutions, handles the resolution and restructuring of the debt of viable companies. Corporate Banking has three support units; Business Solutions, Credit Assessment and Legal Services.

Legal Services, within Corporate Banking, is responsible for preparing more complex loan contracts and collateral agreements. The department also provides legal advice on granting credit, advance types or the issuance of guarantees as well as providing information to account managers and handling communication with lawyers and appointed receivers of bankruptcy estates.

Business Solutions is a support unit designed to be an enabler for the business units by providing in-depth data analysis and business development. Credit Assessment is responsible for the preparation of credit rating reports and supervising business cases, which are submitted for credit decisions.

The Bank's share of the Icelandic corporate banking market is around 37.1% according to a survey conducted by Capacent in February/March 2013.

#### 3.6.1.3 *Markets*

The Markets Division is comprised of four departments; Asset Management, Capital Markets, Market Making and Corporate Finance. The Markets Division has one support unit, Business Solutions.

Capital Markets handles market transactions in foreign currencies and other financial instruments, such as bonds, equities and derivatives, to professional clients. Capital Markets also handles the issue and sale of corporate, municipal and national government bonds.

Capital Markets incorporates Fund & Pension Advisory Services, which provides the Bank's customers with advice and services in matters relating to savings, investments and pensions. The department's main customers are general investors involved in securities trading and individuals and companies in relation to pension issues.

Market Making acts as a market maker for a number of issuers of listed securities, as well as the ISK on the interbank market. The role of a market maker is to promote normal price formation and liquidity on the market by submitting offers to buy or sell the asset to which the market making agreement applies at any time, for its own account within a maximum price range.

Corporate Finance provides advisory services to companies and investors, and is focused on services in relation to the restructuring of companies, among other things, through mergers and acquisitions, purchase and sale of companies and advice on project financing. It also advises on and co-ordinates public offerings and listings on stock exchanges, as well as providing services to companies listed on a stock exchange.

Asset Management offers comprehensive asset management services, including advice in selecting appropriate savings options, and development and management of asset portfolios. The customers of Asset Management are diverse and include individuals, pension funds, institutions, municipalities and companies.

A part of the product offering provided by Asset Management is securities and investment funds run by Landsbréf ehf., an independent subsidiary of the Bank. In addition, Asset Management has two pension funds under full management, which involves asset management of securities portfolios, supervising the funds' accounting, registration of pension rights and pension payments.

Asset Management's services entail the management of asset portfolios by Private Banking Services along with customised management for companies, pension funds, insurance companies, municipalities and charities. Private Banking Services are customised to meet the needs of the Bank's wealthiest customers. Activities involve the management of customer's asset portfolios in addition to general accounting services. Customers can choose between active management of an asset portfolio where the advisors of Private Banking Services manage the assets in accordance with a predetermined investment strategy, or advice on management where the customer manages its own portfolio with the assistance of an advisor.

An Investment Council operates within Asset Management and its purpose is to form an investment policy for customers' asset portfolios, assess risk and identify risk mitigating measures, in addition to being a forum for professional discussions on the best rate of return, opportunities on the market and best practice.

Business Solutions is a support unit designed to be an enabler for the business units by providing business development.

#### *3.6.1.4 Support divisions*

The Bank has four support divisions; Risk Management, Finance, Corporate Development & HR and Operations & IT.

#### *3.6.1.5 Risk Management*

The role of Risk Management is to assess and control the Bank's credit risk, to assess market risk, liquidity risk and operational risk, and monitor these risk factors in the Bank's operations. Risk Management is responsible for maintenance and analysis of the Bank's risk assessment systems. The Division is comprised of five departments: Credit Management, Credit Risk Monitoring, Market Risk, Operational Risk and Models & Analysis.

#### *3.6.1.6 Finance*

Finance is a division that incorporates both support and profit functions. The division is comprised of five departments: Treasury, Accounting & Financial Reporting, Budgeting, Legal and Recalculation.

Treasury is primarily concerned with liquidity management and financing for the Bank, ALM, market-making in the money market and controlling internal pricing of capital. Treasury also handles communications with the Central Bank, domestic and overseas financial institutions, as well as rating agencies. Treasury proposes changes to the Bank's tariff and determines special terms for accounts in collaboration with the branch network. Treasury also manages the Bank's price list.

Accounting & Financial Reporting is responsible for financial accounting and prepares the Bank's monthly, quarterly and annual financial statements. Accounting & Financial Reporting registers and discharges cost accounting. The department manages the accounts of asset custody portfolios and pension funds under management by the Bank.

Budgeting manages the Bank's budgets. Compilation and dissemination of management information is a key part of the department's responsibilities. Budgeting also handles analysis and control; it project manages and edits the Bank's ICAAP.

The Bank's Legal Department handles legal aspects of the Bank's operations. The Legal Department provides the Bank and its subsidiaries with legal advice on points of contention, representation in district courts, preparation of cases reviewed by the Complaints Committee on Transactions with Financial Undertakings and preparation of documents and communication with regulators, especially the FME and Icelandic Competition Authority. The Bank's Legal Department handles collection of all payments in arrears owed to the Bank.

Following Supreme Court ruling No. 155/2011, the Bank created the Recalculation department. Its role is to handle recalculation of exchange rate indexed loans and the correction thereof in the Bank's systems. Currently, its main tasks involve correction of recalculations in accordance with rulings No. 60/2011 and 464/2012. In addition, Recalculation works with Legal on various court proceedings that concern disputes on classification and recalculation of loans and queries on FX-denominated loans.

#### *3.6.1.7 Corporate Development & HR*

Corporate Development & HR is comprised of seven departments: Strategic PMO, Human Resources, the Marketing Department, the Web Department, Sales & Services, Business Development and Corporate Social Responsibility.

Human Resources is responsible for all employee-related issues, such as salary and benefits, recruitment and job development. The Education and Training Department is located within Human Resources.

The Marketing Department is responsible for formulating and implementing the Bank's marketing strategy and planning. The Web Department is responsible for mobile banking and the development and technical maintenance of the intranet and external Internet services, as well as special solutions for the Bank's various divisions.

The role of the Strategic Project Management Office ("Strategic PMO") is to ensure that the Bank's activities progress effectively and professionally, guided by the Bank's strategy. In addition, Strategic PMO oversees the Bank's strategy, which involves conducting reviews, audits and implementation thereof.

The Sales & Services Department is project-driven and is responsible for development in areas relating to the Bank's sales and service quality. The Department provides advice, education and support to the development and implementation of improvement measures in sales and services.

The role of Business Development is to drive innovation in banking services, product development and the Bank's distribution channels. Business Development closely monitors market developments, changes in consumer behaviour and distribution channels.

Corporate Social Responsibility ("CSR") is responsible for defining and forming the Bank's CSR policy and works towards the implementation of CSR in the Bank's daily operations and in its departments and divisions.

#### *3.6.1.8 Operations & IT*

Operations & IT is comprised of five departments: Property, IT, Appropriated Assets, Transaction Services and Loan Administration

The IT Department is responsible for developing, operating and advising on the Bank's information systems and solutions. The Department oversees all internally developed and third-party software, as well as hardware such as data centres, telephone systems, ATMs etc.

The Property Department oversees the Bank's internal operations, i.e. the operation and maintenance of all its properties, including sale or purchase. The Department is also responsible for employees' working facilities, purchase of equipment for the Bank's operations, internal security and relations with external security facilities, custodial operations and archives.

Appropriated Assets handles assets, which the Bank comes to possess through foreclosure or other debt settlement and is responsible for their sale.

Transaction Services provides services to the income divisions of the Bank and to the Bank's customers. Its activities include international transfers, settlement of securities and FX transactions, fund administration for securities and pension funds and back-office functions for pension savings.

Loan Administration takes care of all administration of loans, such as documentation of loan agreements between the Bank and its customers and payments of loans. It is also responsible for the registration and storage of original loan documents.

### 3.6.2 Other divisions

#### 3.6.2.1 CEO's Office

The CEO's Office works closely with the CEO and aids him in his duties. The CEO Office's main responsibilities are to implement the Bank's strategy, handle internal and external communication, including with institutions, public enterprises and various stakeholders. The CEO's Office manages the activities and decisions of the Bank's Board of Directors and executive board and provides follow up.

#### 3.6.2.2 Compliance

Compliance is an independent unit directly under the CEO. Compliance's main responsibilities are to:

- Monitor and regularly assess the functionality of measures established to maintain relevant policies and procedures designed to detect any risk that the Bank might fail to fulfil its obligations pursuant to legislation on securities transactions.
- Assist, support and advice management in the fulfilment of their duties. Provide those employees of the Bank, who are responsible for securities transactions, with the training, advice and assistance necessary to enable them to fulfil the Bank's obligations in accordance with legislation on securities transactions.
- Enforce provisions of the Act on Measures to Combat Money Laundering and Terrorist Financing and make sure that coordinated procedures are developed to ensure the correct execution of the Act.
- Identify, assess and monitor the compliance risks faced by the Bank.
- Implement a document management policy and ensure its compliance within the Bank.

#### 3.6.2.3 Internal Audit

Internal Audit is a part of the Bank's organisational structure and constitutes one aspect of its internal oversight system. The role of the Internal Auditor is to provide independent and objective assurance and advice, which is intended to improve the Bank's operations.

Internal Audit evaluates the functionality of internal controls, risk management and the Bank's governance, and thus supports the Bank in achieving its goals. Internal Audit covers all of the Bank's business units, including its subsidiaries and in addition, the Department has been assigned the role of internal auditing for pension funds managed and operated by the Bank.

The Internal Auditor is appointed by the Bank's Board of Directors and is responsible to the Board and its Audit Committee. Strong emphasis is placed on employees of Internal Audit being independent and autonomous in their work. The Internal Auditor shall ensure that the work undertaken by Internal Audit is performed in accordance with current international standards and best practices, including those of the Institute for Internal Auditors and guidelines issued by the Basel Committee.

## 3.7 Administrative, management, and supervisory bodies

### 3.7.1 Senior Management

**Mr. Steinþór Pálsson, CEO**

Mr. Pálsson was born in 1960. He has extensive experience of managing financial institutions and production companies both in Iceland and abroad, and a great deal of experience of change management and strategy development. Mr. Pálsson holds a degree in business administration from the University of Iceland (1985) and an MBA degree from the University of Edinburgh (1995). He was Managing Director of the Debt Financing Department of Verzlunarbanki Íslands (1984 and 1986-1989) and went on to become the Director of the Credit Division, Investment Loans, Branch Services, Risk Management and Corporate Services with Íslandsbanki hf., in addition to being active in the strategic development of the bank and the merger of its predecessors. He was Chief Financial Officer and Operational Manager of Urður, Verðandi, Skuld ehf. (2001), a biotechnology company and then went on to work for Actavis hf. First, as the Managing Director of Actavis in Malta (2002-2006), then as the Managing Director of Actavis in the US (2006-2008) and as the Managing Director of Strategic Development for the Actavis Group in Iceland (2008-2010). Mr. Pálsson is the Chairman of the Board of Directors of Hömlur ehf. and sits on the board of the Confederation of Icelandic Employers. He is the Chairman of the Executive Board, the Risk and Finance Committee and the Credit Committee. Mr. Pálsson took over as the CEO of Landsbankinn in June 2010.

There are no potential conflicts of interests between any duties of Mr. Pálsson for Landsbankinn and his private interests and/or other duties.

### Mr. Árni Þór Þorbjörnsson, Managing Director of Corporate Banking

Mr. Þorbjörnsson was born in 1970. He holds a degree in law from the University of Iceland and a diploma in business and operational studies as well as a Certificate in Corporate Finance from the Securities & Investment Institute in London. Mr. Þorbjörnsson has worked for Landsbankinn and its predecessor since 1996. During his first years with Landsbankinn he worked on projects such as legal advisory and representation. Mr. Þorbjörnsson was the senior legal officer of the Bank's Corporate Division until 2008 and took over as the Managing Director of the Corporate Division when the new bank was established and following the organisational changes in October 2010, he took over Corporate Banking. Mr. Þorbjörnsson sits on the Board of Directors of Hömlur ehf. and Mótus ehf. He also sits on the Executive Board and the Credit Committee.

There are no potential conflicts of interests between any duties of Mr. Þorbjörnsson for Landsbankinn and his private interests and/or other duties.

### Mr. Helgi Teitur Helgason, Managing Director of Personal Banking

Mr. Helgason was born in 1972. He holds a law degree from the University of Iceland. After graduation, in 1998 he started practising law. He later worked for Landsbankinn on such projects as legal collection, advisory and representation. In spring 2001, Helgi headed the establishment of Intrum hf. and Lögheimtan hf. (now also Pacta hf.) offices in Akureyri. He worked as attorney at law and regional manager in the North of Iceland for Intrum hf. and Lögheimtan hf. until spring 2004. Helgi also provided legal services to unions and their members while at Akureyri. Helgi was the Branch Manager of Landsbankinn's Akureyri branch (2004-2010). Helgi sits on the board of Mótus ehf. He also has a seat on the Executive Board and the Credit Committee.

There are no potential conflicts of interests between any duties of Mr. Helgason for Landsbankinn and his private interests and/or other duties.

### Ms. Hrefna Ösp Sigfinnsdóttir, Managing Director of Markets

Ms. Sigfinnsdóttir was born in 1969. She graduated with a degree in business administration from the University of Iceland (1994) and with a diploma from the Insurance Academy (1994). She is a licensed securities broker in Iceland. Ms. Sigfinnsdóttir joined Landsbankinn in 2010 as Managing Director of Asset Management and has been Managing Director of Markets since October 2012. Ms. Sigfinnsdóttir worked as a fund manager for Arev Securities hf. from 2007 before joining Landsbankinn. She was an analyst and headed the Listing division at the Iceland Stock Exchange (1998-2006). Ms. Sigfinnsdóttir was Head of Retail Banking at Fjárvangur hf. (1994-1998) and worked in the Central Bank's Monetary Policy division (1989). She has served on the boards of various enterprises and associations. Ms. Sigfinnsdóttir has a seat on the Executive Board and Asset Management's Investment Council.

There are no potential conflicts of interests between any duties of Ms. Sigfinnsdóttir for Landsbankinn and her private interests and/or other duties.

### Mr. Hreiðar Bjarnason, Managing Director of Finance and deputy CEO

Mr. Bjarnason was born in 1973. He holds a degree in business administration from the University of Iceland (1999) and an MSc degree in Finance from London Business School (2006). He is a licensed securities broker in Iceland. Mr. Bjarnason has worked for Landsbankinn and its predecessor from 1998, first in Capital Markets and later in the Bank's Treasury division. He assumed the post of Managing Director of Markets and Treasury in Landsbankinn early in 2010 and became Managing Director of Financial Operations in August 2012. Mr. Bjarnason is also deputy CEO of Landsbankinn. Hreiðar is a member of Landsbankinn's Executive Board, its Risk and Finance Committee and represents Landsbankinn on the Board of Framtakssjóður Íslands.

There are no potential conflicts of interests between any duties of Mr. Bjarnason for Landsbankinn and his private interests and/or other duties.

**Ms. Jensína Kristín Böðvarsdóttir, Managing Director of Corporate Development & Human Resources**

Ms. Böðvarsdóttir was born in 1969. She holds a BS degree in advertising from San Jose State University, California (1994), and an MBA, focusing on consumer behaviour and marketing, from the University of San Diego (1996). Ms. Böðvarsdóttir joined Landsbankinn in 2010 as Managing Director of Corporate Development and has been Managing Director of Corporate Development & Human Resources since October 2012. Ms. Böðvarsdóttir headed retail sales and marketing at Síminn hf. from 2007. She was Marketing Director at Globus hf. (2004-2007), Managing Director of Human Resources at IMG hf. (2002-2004), Managing Director of Business Development at Norðurljós hf. (1999-2001) and participated in developing the employment service of Gallup hf. (1997-1999). Ms. Böðvarsdóttir is the Chairman of Frumtak GP ehf. She sits on the Executive Board and is the Chairman of the Security Committee in addition to working with the Remuneration Committee.

There are no potential conflicts of interests between any duties of Ms. Böðvarsdóttir for Landsbankinn and her private interests and/or other duties.

**Ms. Perla Ösp Ásgeirsdóttir, Managing Director of Risk Management**

Ms. Ásgeirsdóttir was born in 1978. She holds an MS degree in finance from the University of Reykjavík. Ms. Ásgeirsdóttir was appointed Head of Risk Management of Landsbankinn in April 2010 and Managing Director of Risk Management in October that same year.

Ms. Ásgeirsdóttir worked for the Central Bank of Iceland and for the Special Investigation Committee of the Icelandic parliament (2005-2010). While at the Central Bank, Perla worked on monitoring financial undertakings and markets, as well as developing risk models for the Icelandic financial market. Ms. Ásgeirsdóttir sits on the Executive Committee, the Credit Committee and the Risk & Finance Committee.

There are no potential conflicts of interests between any duties of Ms. Ásgeirsdóttir for Landsbankinn and her private interests and/or other duties.

**Ms. Ragnhildur Geirsdóttir, Managing Director of Operations & IT**

Ms. Geirsdóttir was born in 1971. She is a mechanical engineer from the University of Iceland (1995) and completed graduate studies in industrial engineering (1996) and operations management (1998) from the University of Wisconsin - Madison, USA. Ms. Geirsdóttir joined Landsbankinn in October 2012 as Managing Director of Operations & IT. Ms. Geirsdóttir has extensive management experience. She was the CEO of Promens hf. (2006 to 2011), CEO of Icelandair hf. and FL Group hf. (2005) and held several positions with Icelandair such as SVP of Resource Management (1999-2005). Ms. Geirsdóttir worked at the Icelandic Investment bank as project manager in Capital Markets and M&A (1998-1999) and was a lecturer at the University of Iceland and University of Reykjavík (1998–2002). Ms. Geirsdóttir has served on the boards of many companies both in Iceland and abroad, including Landsbréf hf., Skeljungur hf., Distica hf., Horn Investment Company hf., Icelandair Group hf. and the Icelandic Stock Exchange

Ms. Geirsdóttir sits on the Executive Board and the Risk & Finance Committee. She sits on the Board of Directors of Horn Investment company hf. and Hömlur ehf. and its subsidiaries.

There are no potential conflicts of interests between any duties of Ms. Geirsdóttir for Landsbankinn and her private interests and/or other duties.

### *3.7.2 Board of Directors*

The Issuer's Board of Directors consists of seven persons and two alternates. The chairman of the Board of Directors is elected individually. The Board of Directors is elected at an Annual General Meeting for a term of one year. The Icelandic State Financial Investments (*Ice. "Bankasýsla ríkisins"*) submits a proposal for the election to the Board of Directors to the Annual General Meeting.

In electing members to the Board of Directors, the aim is to ensure a gender balance and that the Board of Directors as a whole possesses in-depth knowledge of banking activities.

**Mr. Tryggvi Pálsson, Chairman of the Board**

Mr. Pálsson was born in 1949. He graduated with a degree in business administration from the University of Iceland (1974) and an M.Sc. (Econ.) from London School of Economics (1975). Mr. Pálsson has an extensive experience of the financial market and has played a leading role in the operation of numerous financial undertakings. Mr. Pálsson worked for LBI hf. as Chief Economist (1976-1984) and as Executive Director of Finance (1984-1988). In 1998 he worked as co-CEO of the Iceland Bank of Commerce and subsequently played a key role in the merger of four Icelandic banks to form Íslandsbanki hf. in 1990. He was co-CEO and later Director of Corporate and Markets of Íslandsbanki hf. (1990-2000). Mr. Pálsson was Advisor to the Board of Governors of the Central Bank of Iceland (2000-2001) and Director of Financial Stability at the Central Bank of Iceland (2001-2011). Mr. Pálsson has been a board member in e.g. ISB Holding ehf., the Financial Supervisory Authority, Icelandic Banks' Data Centre, the OMX Nordic Exchange Iceland, the Icelandic Securities Depository, the Association of Icelandic Banks, Glitnir hf. (asset leasing), Kreditkort hf., Fjárfestingarfélag Íslands hf. and Féfang hf. He has been a member of several publicly commissioned committees, worked with several non-governmental organizations and taught macroeconomics and banking theory at university level. Mr. Pálsson chairs two sub-committees of the Board of Directors; the Remuneration Committee and the Strategic Development Committee. Mr. Pálsson was first elected as Chairman of Landsbankinn's Board of Directors in April 2013.

There are no potential conflicts of interests between any duties of Mr. Pálsson for Landsbankinn and his private interests and/or other duties.

**Ms. Eva Sóley Guðbjörnsdóttir, Vice-chairman of the Board**

Ms. Guðbjörnsdóttir was born in 1981. She graduated with an M.Sc. degree in financial engineering from Columbia University in the US (2006) and had previously studied economic engineering and economics at the same institution. Ms. Guðbjörnsdóttir is a licensed securities broker. She is an independent consultant, director and part-time lecturer in a master's level programme in financial engineering at Reykjavík University. She held various positions at Kaupthing Bank (2003-2008) in treasury, funding and liquidity management, corporate banking and corporate finance. She was Managing Director of Kaupthing's creditor and portfolio management department (2008-2009) and Chief Financial Officer (2009-2011), responsible for overseeing the bank's financial and administrative areas along with unwinding the derivatives portfolio and portfolio management for cash, loans, securities and subsidiaries. She served as alternate to the Board of Directors of Íslandsbanki (2012-2013). Ms. Guðbjörnsdóttir sits on two sub-committees of the Board of Directors, the Audit and Risk Committee and the Strategic Development Committee. Ms. Guðbjörnsdóttir was first elected to Landsbankinn's Board of Directors in April 2013.

There are no potential conflicts of interests between any duties of Ms. Guðbjörnsdóttir for Landsbankinn and her private interests and/or other duties.

**Ms. Danielle Pamela Neben**

Ms. Neben was born in 1970. She completed a Bachelor of Commerce with a major in Finance and a minor in German from McGill University in Canada (1993). Ms. Neben has worked for HSBC, one of the largest banks worldwide, since 1993 in seven countries including the UK, Germany, Taiwan and Brazil. At present, Ms. Neben is a Member of the Management Board of HSBC Trinkaus & Burkhardt (International) SA in Luxembourg as Chief Operations Officer. She has previously held various managerial roles in HSBC, including investor relations, retail banking, corporate banking, and debt recovery and restructuring. Ms. Neben sits on two sub-committees of the Board of Directors, the Audit and Risk Committee and the Strategic Development Committee. Ms. Neben was first elected to Landsbankinn's Board of Directors in April 2013.

There are no potential conflicts of interests between any duties of Ms. Neben for Landsbankinn and her private interests and/or other duties.

**Ms. Helga Björk Eiríksdóttir**

Ms. Eiríksdóttir was born in 1968. She holds an MBA from the University of Edinburgh (2006). Ms. Eiríksdóttir graduated from the University of Iceland with a BA degree in English and Italian (1997) and completed a degree in journalism from the same institution (1999). Ms. Eiríksdóttir completed a degree in marketing and export management with the Department of Continuing Education at the Reykjavík University (2002). Ms. Eiríksdóttir is Managing Diretor of Integrum, a company that operates in the field of real estate development and advisory services. Previously, she was Investor Relations and PR manager for Marel and chaired the Board of Directors of Sparisjóður Svarfdæla. She worked as an independent consultant (2010-2012) and handled PR for the Resolution Committee and Winding-up Board of Kaupthing hf. (2009-2010). Previously, Ms. Eiríksdóttir spent eight years working as marketing and PR manager of Nasdaq OMX Iceland. Ms. Eiríksdóttir has also worked in construction, media, various other sectors and for savings bank Sparisjóður Svarfdæla at Dalvík for a longer period. Ms. Eiríksdóttir sits on the Remuneration Committee of the Board of Directors. Ms. Eiríksdóttir was first elected to Landsbankinn's Board of Directors in April 2013.

There are no potential conflicts of interests between any duties of Ms. Eiríksdóttir for Landsbankinn and her private interests and/or other duties other than stated above.

**Mr. Jón Sigurðsson**

Mr. Sigurðsson was born in 1954. He has a degree in business administration from the University of Iceland (1979). Mr. Sigurðsson works as Senior Vice President of Procurement at Promens hf. He previously worked as CFO for the same company from its establishment until 2007. Mr. Sigurðsson was Head of investment at Framtak Investment Bank (1999-2004). He worked for Coca-Cola (1991-1999), first as CFO of Vífilfell hf., local bottler in Iceland and later for the Coca-Cola Company's regional office in Norway, initially as controller and later in business development. Mr. Sigurðsson worked as CFO of Hans Petersen hf. (1986-1991), prior to which he was a consultant at Hagvangur hf. Jón has served on the Board of Directors of numerous domestic and foreign companies. He was first elected as alternate to Landsbankinn's Board of Directors in April 2010 and has been a regular member of the Board of Directors since April 2013. Mr. Sigurðsson sits on the Strategic Development Committee of the Board of Directors.

Horn Invest hf., a subsidiary of Landsbankinn, holds 49.9% of shares in Promens hf. and Framtakssjóður Íslands slhf. (FSÍ) holds the remaining shares in Promens hf. Landsbankinn owns a 27.6% shareholding in FSÍ. There are no potential conflicts of interests between any duties of Mr. Sigurðsson for Landsbankinn and his private interests and/or other duties other than stated above.

**Mr. Kristján Þ. Davíðsson**

Mr. Davíðsson was born in 1960. Mr. Davíðsson is a Master Mariner from the Icelandic College of Navigation (1980) and holds a master's degree in fisheries science from the University of Tromsö in Norway (1987). He has been Managing Director of Isder ehf. since 2009. Previously he was Managing Director of the Resolution Committee appointed to Glitnir Bank hf. (2008-2009) and had before that worked for Glitnir/Íslandsbanki hf. as Managing Director of corporate banking, Head of the international seafood industry team and Senior Business Manager from 2001-2003 and from 2005-2008. He was CEO of Grandi hf. (2003 to 2004) and Deputy CEO of HB Grandi hf. (2004-2005). He worked for Marel hf. in sales and marketing from 1994 to 2000 and as Sales Manager for SÍF HF. (1990-1994). He was CEO of Norfish Export Co. in Norway (1990-1998) and Export Manager for Kapro Nor AS, also in Norway, (1987-1988). Mr. Davíðsson is Vice-chairman of the Board of Directors of Norwegian fishing and fish processing company Copeinca ASA. He is Chairman of the Board of Directors of Valka hf. and Member of the Board of Directors of Vaki fiskeldiskerfi hf., Icelandic seafood industry technology companies. He is the honorary consul of Brazil in Iceland. He was first elected as alternate to the Board of Directors of Landsbankinn in April 2011 and has been a regular member of the Board of Directors since April 2013. Mr. Davíðsson sits on the Remuneration Committee of the Board of Directors.

There are no potential conflicts of interests between any duties of Mr. Davíðsson for Landsbankinn and his private interests and/or other duties.

**Ms. Þórdís Ingadóttir**

Ms. Ingadóttir was born in 1969. She is cand.jur. from the University of Iceland (1993) and holds an LL.M in International Law from New York University's School of Law (1998). She is an Associate Professor at the School of Law at University of Reykjavík since 2005. She was a faculty member at New York University (1999-2003) and a legal officer at the legal division of the Icelandic Ministry of Justice and Ecclesiastical Affairs (2004). Ms. Ingadóttir has held various appointments from the government, international institutions, universities and non-governmental organizations. Ms. Ingadóttir was first elected to the Board of Directors of Landsbankinn in April 2010. Ms. Ingadóttir chairs the Board's Audit & Risk Committee.

There are no potential conflicts of interests between any duties of Ms. Ingadóttir for Landsbankinn and her private interests and/or other duties.

**Ms. Helga Loftsdóttir, alternate**

Ms. Loftsdóttir was born in 1962. She has a cand.jur. degree from the University of Iceland (1991) and was recognised as a District Court Attorney in 1997. She has been a partner in and managed law firm Þ&L sf. since 1997. She worked for legal firm Garðastræti 17 sf. (1991-1994) and as a lawyer for the Directorate of Internal Revenue (1994-1997). Ms. Loftsdóttir was a member of the Board of savings bank SpKef from its establishment in 2010 until it was taken over by Landsbankinn in 2011. Ms. Loftsdóttir was first elected as alternate to the Board of Directors of Landsbankinn in April 2010.

There are no potential conflicts of interests between any duties of Ms. Loftsdóttir for Landsbankinn and her private interests and/or other duties.

**Dr. Tinna Laufey Ásgeirsdóttir, alternate**

Dr. Ásgeirsdóttir was born in 1975. She gained a PhD in Economics from the University of Miami in 2006, prior to which she concluded master's studies in economics at the same university and studied history at the University of Iceland and Copenhagen University. She has held teaching and research positions both in Iceland and abroad and currently works as an Assistant Professor of Economics at the University of Iceland. Her work has been published in numerous scientific journals and books, domestic and international. She has on many occasions consulted for both companies and institutions. Dr. Ásgeirsdóttir has held various executive positions in the field of science and teaching, including a seat on the Council of the University of Iceland. Dr. Ásgeirsdóttir was first elected as alternate to the Board of Directors of Landsbankinn in March 2012.

There are no potential conflicts of interests between any duties of Dr. Ásgeirsdóttir for Landsbankinn and her private interests and/or other duties.

The address for members of the Board of Directors and Senior Management is: Austurstræti 11, 155 Reykjavík, Iceland.

# 4 THE ICELANDIC ECONOMY[1]

The Icelandic economy is small and in terms of GDP it is the smallest economy within the OECD with a total GDP of ISK 1,708 billion (EUR 10.6 billion) in 2011. The population is also small, about 320,000 inhabitants. GNI per capita measured in terms of purchasing power parity ("PPP"), ranks nineteenth highest among the OECD countries at USD 31,640 in 2011, marginally below the EU average.

Historically, economic prosperity in Iceland has been built largely on abundant marine and energy resources, with investment and services as the main drivers of economic growth. Non-tradable services form the bulk of economic activity, accounting for approximately 63% of GDP in 2012. The marine sector is still one of the most important sources of export revenues and accounts for 12% of GDP in 2012 (down from 16% in 1980). Exports of services, driven by a booming tourist sector, are an increasingly important source of export revenues. Services now account for roughly 35% of total export revenues, up from 26% in 1990. The share of manufacturing and energy was 16% of GDP in 2012 (up from 14% in 1999-2005).

In 2008, the Icelandic economy entered into a deep recession after a five-year period of robust but unsustainable economic growth. The growth was initially spurred by investments in the aluminium and power sectors, followed by a p henomenal growth of the banking sector accompanied by a cr edit boom, sustained by easy access to global credit. The growth soon became increasingly imbalanced which was reflected e.g. by a rapidly growing current account ("CA") deficit and mounting inflationary pressures. The recession was triggered by a twin currency and banking crisis of autumn 2008. Domestic demand contracted by nearly 30% from its peak in 2006 to its trough in 2010.

Following the collapse of the financial sector, the central government reached an agreement with the Inernational Monetary Fund ("IMF") on an economic stabilisation programme, under a two-year stand-by arrangement. The programme involved i.e. access to foreign funding from the IMF and bilateral loans from the Nordic countries and Poland. It also involved capital controls which significantly restrict transfer of capital out of the economy.

After a period of austerity measures and restructuring of the financial sector, growth resumed in 2011 as GDP grew by 2.9%, in 2012 growth continued at 1.6%. Unemployment peaked at 11.9% in early 2010 but was down to 3.9% in June 2013, well below the EU average. The exchange rate of the króna has stabilised significantly after losing almost 50% of its value against the euro from January 2008 to November 2009. End of July 2013 the króna had appreciated by 15% since its lowest level in the end of 2009.

Despite a significant trade account surplus, 6.3% of GDP in 2012, the CA balance was negative by 4.9% of GDP that year. Adjusted for calculated income and expenses of Deposit Money Banks ("DMB") in winding-up proceedings and the effects of the settlement of their estates and for the pharmaceutical company Actavis hf.; the CA surplus is estimated at 3.1% of GDP in 2012.

Statistics Iceland forecasts an average annual GDP growth of 2.6% in 2013-2018, driven by growing investment and private consumption. Annual CPI inflation in July 2013 measured 3.8%, slightly above the 2.5% inflation target of the Central Bank of Iceland.

## 4.1 The residential housing market in Iceland

Developments in the housing market in Iceland for the last 10 years are closely intertwined with the economic upswing that began in 2003 and ended abruptly in October 2008 with the collapse of the banking sector. The upswing began when construction commenced on a large foreign-owned aluminium smelter and an associated state-owned power plant. In combination, these investments were equivalent to more than one-third of 2003 GDP. These projects were accompanied by a credit boom resulting from a combination of favourable global financial conditions and sweeping changes in Iceland's financial system, including the full privatisation of major banks in 2003 and their subsequent expansion abroad, as well as changes in the domestic mortgage market.

In the summer of 2004, substantial changes were introduced to the Icelandic housing market. The state-owned mortgage lender, the Housing Financing Fund ("HFF"), changed its system for backing residential mortgages. Following these changes the newly privatized commercial banks entered the market and engaged the HFF in direct competition. HFF had traditionally been the main provider of mortgage loans to households. The commercial banks offered new products in the consumer loan market, including mortgage loans with longer

[1] Sources: This chapter was compiled by Landsbankinn's Economic Research Department based on data and information obtained from Statistics Iceland and the Central Bank of Iceland, 30 May 2013.

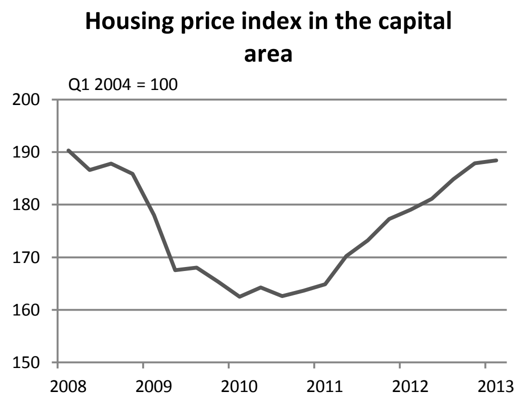
maturities, lower interest rates, higher loan-to-value ratio, and later foreign currency indexed loans. Housing purchases were no longer a precondition for a l oan, which facilitated refinancing and mortgage equity withdrawal. These changes had a profound impact on the housing and construction sector. Demand for housing increased significantly, followed by dramatic price increases and a boom in housing construction. A lot of land was developed and sold for residential and commercial housing. Housing construction rose steadily during this period, partly due to the fact that building costs rose much slower than property prices.

Traditionally most mortgage loans in Iceland have been CPI-indexed but during the boom years an increasing number of mortgage loans were linked to foreign currencies. Thus, mortgage borrowers were vulnerable to extreme fluctuations in inflation and the exchange rate, as well as to a fall in house prices. In the autumn of 2008, households were hit by all of these factors. The exchange rate fell drastically, inflation rose, the housing market froze and mortgage payments became increasingly difficult for a significant share of households.

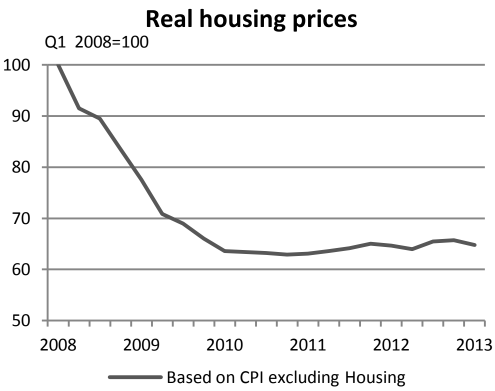
The banks and the central government have undertaken various measures focused at aiding the restructuring of household debt through other means than bankruptcy. This includes for example an agreement on a formal process for writing down mortgages to 110% of the value of mortgaged assets. The road to recovery has been long and bumpy but signs of a return to normality in the housing market have begun to emerge.

Housing prices peaked in Q1 2008 after an almost continuous rise since 1996. There was a sharp turn upwards in 1999 and then again in 2004. Historically the nominal value of residential housing in Iceland is sticky downwards. The index was at its lowest point in Q1 2010, and based on the highest value before the crises, prices fell by 15% in approximately 2 years. The nominal price changed insignificantly in 2010 but has since then risen steadily. The nominal prices as of April 2013 are 1% lower than at the peak in 2008. The number of transactions on the property market is still much lower than during the boom years but the turnover and number of transactions has increased steadily since 2009.

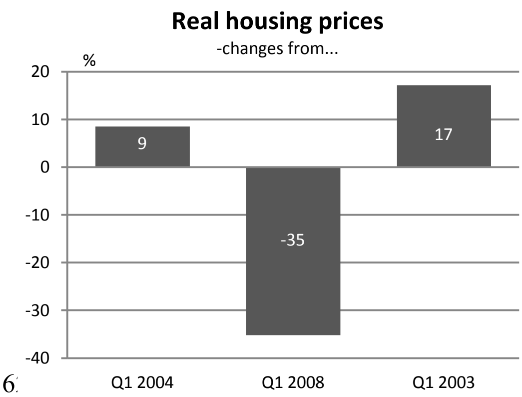
The most significant part of the adjustment to the property market after the collapse took place through inflation and changes in real prices. The nominal value of housing prices decreased by 1% from Q1 2008 when it peaked until Q1 2013 while general consumer prices (excluding housing) increased by around 53%. This means that the real decline in housing prices has been 35%. In comparison with other periods the real housing prices are now 9% higher than in the beginning of 2004 and 17% higher than in the first quarter in 2003. Taking the recent positive development of the economy into consideration, it is not unreasonable to assume that nominal housing prices reached bottom already in 2010.




*Source: National Registry, Landsbankinn Economic Research*




*Source: National Registry, Landsbankinn Economic Research*




*Source: National Registry, Landsbankinn Economic Research*

## 4.2 Financial Markets in Iceland

### *4.2.1 Market participant and supervision*

Icelandic credit institutions are comprised of four commercial banks, nine savings banks and six credit institutions. The financial market also includes eleven securities companies, two securities brokerages and nine management companies of UCITS[2]. A Housing Financing Fund, a fully state-owned institution, operates in Iceland and offers financing for residential housing in Iceland.

One stock exchange is operated in Iceland, the Nasdaq OMX Iceland hf. and one securities depository, Verðbréfaskráning Íslands hf.

Icelandic financial markets are supervised by the FME. Entities engaging in financial activities which are subject to license are regulated by FME, including credit institutions, insurance companies and pension funds. The activities of FME are largely governed by Act No. 87/1998, on the Official Supervision of Financial Operations.

The Central Bank of Iceland is in charge of monetary policy implementation in Iceland and performs a wide range of functions to this end. The main objective of monetary policy is price stability. The activities of the Central Bank of Iceland are largely governed by Act No. 36/2001, on the Central Bank of Iceland. The Central Bank imposes a r eserve requirement on all the commercial banks and savings banks. The purpose of this limitation is to ensure that credit institutions have sufficient margin to the reserve requirement account to meet fluctuations in their liquidity positions. Foreign exchange transactions have been subject to capital controls since the banking system collapse in 2008. The Central Bank oversees surveillance of the Rules on Foreign Exchange.

### *4.2.2 Size of the banking system*

Total assets of Icelandic credit institutions, i.e. commercial banks, savings banks and credit undertakings amounted to ISK 3.008 billion at 30 June 2013, out of which foreign assets were ISK 425 billion, or 14%.[3] The Icelandic financial market is therefore highly exposed to the Icelandic economy.

The total assets of the three largest commercial banks, the Issuer, Íslandsbanki hf. and Arion Bank hf., comprise around 73% of the total assets of Icelandic credit institutions at 30 June 2013. The proportion of the Housing Financing Fund is 22%.[4]

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2 Source: The Financial Supervisory Authority, http://en.fme.is/supervision/supervised-entities/

3 Source: The Central Bank of Iceland, http://www.cb.is/statistics/statistics/2013/07/25/Monetary-statistics/

4 Page 18 of the Annual Report of the Financial Supervisory Authority, http://www.fme.is/utgefid-efni/frettir-og-tilkynningar/frettir/nr/1822.

# 5 APPLICABLE FINAL TERMS

*Set out below is the form of Final Terms which will be completed for each Tranche of Covered Bonds issued under the Programme.*

[*Date*]

**LANDSBANKINN HF.**
**Issue of [Aggregate Nominal Amount of Tranche] [Title of Covered Bonds]**
**under the ISK 100,000,000,000 Covered Bond Programme**

**PART A – CONTRACTUAL TERMS**

Terms used herein shall be deemed to be defined as such for the purposes of the Terms and Conditions of the Covered Bonds (the **Terms and Conditions**) set forth in the Base Prospectus dated 3 October 2013. This document constitutes the Final Terms of the Covered Bonds described herein for the purposes of Article 5(4) of the Prospectus Directive, as amended (which includes the amendments made by Directive 2010/73/EU) and Article 45 of Act on Securities Transactions and must be read in conjunction with the Base Prospectus and any supplements if applicable which constitute a base prospectus for the purposes of the Prospectus Directive. Full information on the Issuer and the offer of the Covered Bonds is only available on the basis of the combination of these Final Terms and the Base Prospectus and any supplements, if applicable. A copy of said Base Prospectus is available for viewing at the issuer's website, www.landsbankinn.is/sertryggd-skuldabref.

[*Include whichever of the following apply or specify as "Not Applicable" (N/A). Note that the numbering should remain as set out below, even if "Not Applicable" is indicated for individual paragraphs or subparagraphs. Italics denote directions for completing the Final Terms*.]

[*When adding any other final terms or information consideration should be given as to whether such terms or information constitutes "significant new factors" and consequently trigger the need for a supplement to the Base Prospectus under Article 16 of the Prospectus Directive*.]

| | |
|---|---|
| **1. Issuer:** | **Landsbankinn hf.** |
| **2.** | |
| i. Series Number: | [ ] |
| ii. Tranche Number: | [ ]<br>(*If fungible with an existing Series, details of that Series, including the date on which the Covered Bonds become fungible*) |
| **3. Specified Currency or Currencies:** | [ ] |
| **4. Aggregate Nominal Amount:** | |
| i. Series: | [ ] |
| ii. Tranche: | [ ] |
| **5. Issue Price:** | [ ] per cent. of the Aggregate Nominal Amount [plus accrued interest from [*insert date*] (*if applicable*)] |
| **6. Specified Denominations:** | |
| i. Specified Denominations:<br>(in the case of Registered Covered Bonds this means the minimum integral amount in which transfers can be made) | [ ]<br>*(N.B. Following the entry into force of the 2010 PD Amending Directive on 31 December 2010, Covered Bonds to be admitted to trading on a regulated market within the European Economic Area with a maturity* |

*date which will fall after the implementation date of the 2010 PD Amending Directive in the relevant European Economic Area Member State (which was due to be no later than 1 July 2012) must have a minimum denomination of EUR 100,000 (or equivalent) in order to benefit from Transparency Directive exemptions in respect of wholesale securities. Similarly, Covered Bonds issued after the implementation of the 2010 PD Amending Directive in a Member State must have a minimum denomination of EUR 100,000 (or equivalent) in order to benefit from the wholesale exemption set out in Article 3.2(d) of the Prospectus Directive in that Member State.)*

*(Note – where Bearer Covered Bonds with multiple denominations above €100,000 or equivalent are being used the following sample wording should be followed:*

*"€100,000 and integral multiples of [€1,000] in excess thereof up to and including €199,000. No Covered Bonds in definitive form will be issued with a denomination above €199,000.")*

*(N.B. If an issue of Covered Bonds is (i) NOT admitted to trading on an European Economic Area exchange; and (ii) only offered in the European Economic Area in circumstances where a prospectus is not required to be published under the Prospectus Directive, the €100,000 minimum denomination is not required*.)

| | | | |
|---|---|---|---|
| | ii. | Calculation Amount: | [ ]<br><br>(If only one Specified Denomination, insert the Specified Denomination. If more than one Specified Denomination, insert the highest common factor. Covered Bond: There must be a common factor in the case of two or more Specified Denominations.) |
| **7.** | | | |
| | i. | Issue Date: | [ ] |
| | ii. | Interest Commencement Date: | [ ] |
| **8.** | | | |
| | i. | Maturity Date: | [*Specify date*] |
| | ii. | Extended Maturity Date: | [Applicable/Not Applicable]<br>(*If not applicable, delete the remaining sections of this subparagraph*)<br><br>The Extended Maturity Date is [*specify date or Interest Payment Date falling in or nearest to the relevant month and year; in each case falling one year after the Maturity Date]*.<br><br>*[If applicable, complete relevant sections regarding interest, etc.]* |
| **9.** | | | |
| | i. | Interest Basis to Maturity Date: | [Inflation Linked Interest] |

| | |
|---|---|
| | [[] per cent. Fixed Rate]<br>[[LIBOR/EURIBOR/REIBOR] +/- [ ] per cent. Floating<br>[Zero Coupon]<br>*[specify other]* |
| ii. Interest Basis from Maturity Date to Extended Maturity Date: | [Inflation Linked Interest]<br>[[] per. cent. Fixed Rate]<br>[[LIBOR/EURIBOR/REIBOR] +/- [ ] per cent. Floating<br>[Zero Coupon]<br>*[specify other]* |
| **10. Redemption/Payment Basis:** | [Annuity]<br>[Redemption at par]<br>[Equal principal payments]<br>[Instalment]<br>[*specify other*]<br><br>(N.B. If the Final Redemption Amount is other than 100% of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.) |
| **11. Change of Interest Basis or Redemption/Payment Basis:** | [*Specify details of any provision for change of Covered Bonds into another Interest Basis or Redemption/Payment Basis*/*Not Applicable*] |
| **12. Investor Put/Issuer Call:** | [Investor Put/Not Applicable]<br>[Issuer Call/ Not Applicable]<br>[(*further particulars specified below*)] |
| **13. Status of the Covered Bonds:** | Senior/*[specify other]* |
| **14. Approval for Issuance of the Covered Bonds:** | Date of [Board] approval for issuance of Covered Bonds obtained]:<br>[Date/ Not Applicable]<br><br>(*N.B. Only relevant where Board (or similar) authorization is required for the particular Tranche of Covered Bonds*) |
| **15. Method of Distribution:** | [Syndicated/Non-syndicated] |
| **16. Calculation Agent:** | [Issuer*/(specify other)*] |

**PROVISIONS RELATING TO INFLATION LINKED ANNUITY COVERED BONDS**

| | |
|---|---|
| **17. Inflation Linked Annuity Covered Bonds:** | [Applicable/Not Applicable]<br>(*if not applicable, delete the remaining subparagraphs of this paragraph*)<br><br>*(N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the* |

*Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.)*

| | | |
|---|---|---|
| i. | Rate(s) of Interest to Maturity Date: | [ ] per cent. per annum [payable [annually/semi-annually/quarterly/monthly] in arrears] |
| ii. | Rate(s) of Interest from Maturity Date to Extended Maturity Date: | [ ] per cent. per annum [payable [annually/semi-annually/quarterly/monthly] in arrears] |
| iii. | Number of Interest Payment Dates: | [ ] |
| iv. | Interest Payment Date(s): | [The [ ] day in the months of [ ] and [ ] in each year up to and including the Maturity Date]. First Interest Payment Date being [ ] |
| v. | Day Count Fraction: | [30/360] [*specify other*] |

vi. Principal Repayment(s):

An amount calculated by the Issuer on each Interest Payment Date by multiplying the nominal amount on the Issue Date with the Index Ratio and with the factor A, which is calculated according to the following formula:

$$A = \frac{r * (1+r)^{k-1}}{(1+r)^{n} - 1}$$

where,
A = Principal repayment factor

$r = \frac{c}{f}$

c = The rate of interest of the relevant bond

f = The number of interest payments per year

n = Number of Interest Payment Dates

k = the number of payments that have already been made (k=0 on the Issue Date, k=1 on the first Interest Payment Date, k=n on the last Interest Payment Date, etc.)

vii. Interest Payment(s):

Interest is calculated on each Interest Payment Date as the nominal amount on the Issue Date multiplied with the Index Ratio and with the factor I, which is calculated according to the formula:

$$I_k = \frac{r * \left[ (1+r)^{n} - (1+r)^{k-1} \right]}{(1+r)^{n} - 1}$$

where,
$I_k$ = Interest repayment factor for period k

$r = \frac{c}{f}$

c = The rate of interest of the relevant bond

f = The number of interest payments per year

n = Number of Interest Payment Dates

k = the number of payments that have already been made
(k=0 on the Issue Date, k=1 on the first Interest Payment Date, k=n on the last Interest Payment Date, etc.)

viii. Payment(s):

On each Interest Payment Date the sum of the relevant Principal Repayment and the Interest Payment.

ix. Index Ratio:

The value of the Index Ratio (**IR**) on the relevant Interest Payment Date shall be the value of the Reference Index (**RI**) applicable to the relevant Interest Payment Date divided by the value of the Base Index (**BI**) as calculated by the Issuer:

$$IR = \frac{RI_t}{BI}$$

where,

**Reference Index** or **$RI_t$** means on each Interest Payment Date:

For each day in the calendar month and number RI rounded to 5 decimals:

$$RI = CP_{M-2} + \left[\frac{d-1}{D} * \left(CP_{M-1} - CP_{M-2}\right)\right]$$

where,

**$CP_{M-1}$** = CPI value published by Statistic Iceland in the month preceding month M

**$CP_{M-2}$** = CPI value published by Statistic Iceland 2 months prior to month M

**d** = the relevant calendar date

**D** = number of calendar days in the relevant calendar month

Provided that if the Reference Index in i) or ii) is lower than the Base Index, the Reference Index shall equal the Base Index.

And

**Base Index** means [*to be inserted*], being the value of the CPI on [*to be inserted*].

If at any time a new index is substituted for the CPI, as of the calendar month from and including that in which such substitution takes effect:

(i) the Reference Index shall be deemed to refer to the new index; and

(ii) the new Base Index shall be the product of the existing Base Index and the Reference Index immediately following such substitution, divided by the Reference Index immediately prior to such substitution.

**PROVISIONS RELATING TO INFLATION LINKED EQUAL PRINCIPAL PAYMENT COVERED BONDS INCLUDING COVERED BONDS WITH ONE PAYMENT OF PRINCIPAL ON MATURITY DATE**

| | | |
|---|---|---|
| **18. Inflation Linked Equal Principal Payment Covered Bonds:** | | [Applicable/Not Applicable]<br>(*if not applicable, delete the remaining subparagraphs of this paragraph*)<br><br>(*N.B. If the Final Redemption Amount is other than 100 per cent. of the nominal value the Covered Bonds will be derivative securities for the purposes of the Prospectus Directive and the requirements of Annex XII to the Prospectus Directive Regulation will apply.*) |
| i. | Rate(s) of Interest to Maturity Date: | [ ] per cent. per annum [payable [annually/semi-annually/quarterly/monthly] in arrears |
| ii. | Rate(s) of Interest from Maturity Date to Extended Maturity Date: | [ ] per cent. per annum [payable [annually/semi-annually/quarterly/monthly]in arrears |
| iii. | Number of Interest Payment Dates: | [ ] |
| iv. | Interest Payment Date(s): | [The [ ] day in [month] up to and including the Maturity Date] |
| v. | Number of Interest Payment Dates: | [Number of Interest Payment Dates] |
| vi. | Principal Payment Date(s): | [On each Interest Payment Date/Maturity Date] |
| vii. | Day Count Fraction: | [30/360 /Actual/Actual (ISMA)/[*specify other*]] |
| viii. | Principal Repayment(s): | An amount calculated by the Calculation Agent on each Principal Payment Date by multiplying the Principal Amount Outstanding on the Issue Date with the Index Ratio and dividing with the number of principal Payment Dates. |
| ix. | Interest Payment(s): | Interest is calculated on each Interest Payment date as the Principal Amount Outstanding on each Interest Payment Date multiplied with the Rate of Interest and, the appropriate Day Count Fraction. |
| x. | Payment(s): | On each Interest Payment Date the sum of the relevant Principal Repayment and the Interest Payment. |
| xi. | Principal Amount Outstanding: | On the relevant Interest Payment Date, the Principal Amount Outstanding is calculated based on the following formula: |

$$PAO_t = (PAO_{t-1} - PR_{t-1})\frac{IR_t}{IR_{t-1}}$$

where,

**$PAO_t$** means the Principal Amount Outstanding on the relevant Interest Payment Date.

**$PAO_{t-1}$** means the Principal Amount Outstanding on the preceding Interest Payment Date.

**$PR_{t-1}$** means the Principal Repayment on the preceding Interest Payment Date.

**$IR_t$** means the Index Ratio on the relevant Interest Payment Date.

**$IR_{t-1}$** means the Index Ratio on the preceding Interest Payment Date (Issue Date for the first Interest Payment Date).

xii. Index Ratio:

The value of the Index Ratio (**IR**) on the relevant Interest Payment Date shall be the value of the Reference Index (**RI**) applicable to the relevant Interest Payment Date divided by the value of the Base Index (**BI**) as calculated by the Issuer:

$$IR = \frac{RI_t}{BI}$$

where,

**Reference Index** or **$RI_t$** means on each Interest Payment Date:

For each day in the calendar month and number RI rounded to 5 decimals:

$$RI = CP_{M-2} + \left[\frac{d-1}{D} * \left(CP_{M-1} - CP_{M-2}\right)\right]$$

where,

**$CP_{M-1}$** = CPI value published by Statistics Iceland in the month preceding month M

**$CP_{M-2}$** = CPI value published by Statistics Iceland 2 months prior to month M

**d** = the relevant calendar date

**D** = number of calendar days in the relevant calendar month Provided that if the Reference Index is lower than the Base Index, the Reference Index shall equal the Base Index.

And

**Base Index** means [*to be inserted*], being the value of the CPI on [*to be inserted*]. If at any time a new index is substituted for the CPI, as of the calendar month from and including that in which such substitution takes effect:

i. the Reference Index shall be deemed to refer to the new index; and

ii. the new Base Index shall be the product of the existing Base Index and the Reference Index immediately following such substitution, divided by Reference Index immediately prior to such substitution.

**PROVISIONS RELATING TO INTEREST (IF ANY) PAYABLE**

| | |
|---|---|
| **19. Fixed Rate Covered Bond Provisions:** | [Applicable/Not Applicable]<br>(*If not applicable, delete the remaining subparagraphs of this paragraph*) |
| i. Rate(s) of Interest to Maturity Date: | [ ] per cent. per annum [payable[annually/semi-annually/quarterly] in arrears] |
| ii. Rate(s) of Interest from Maturity Date to Extended Maturity Date: | [ ] per cent. per annum [payable [annually/semi-annually/quarterly] in arrears] |
| iii. Interest Payment Date(s): | [[ ] in each year up to and including the Maturity Date]/ [*specify other*]<br><br>(*N.B. This will need to be amended in the case of long or short coupons*.) |
| iv. Day Count Fraction: | [30/360 /Actual/Actual (ISMA)/[*specify other*]] |
| v. Other terms relating to the method of calculating interest for Fixed Rate Covered Bonds: | [None/*give details*] |
| **20. Floating Rate Covered Bond Provisions:** | [Applicable/Not Applicable]<br>(*If not applicable, delete the remaining subparagraphs of this paragraph*) |
| i. Specified Period(s)/Specified Interest Payment Dates: | [ ]<br>*[NB: Specify the Specified Period(s)/Specified Interest Payment Date(s) up to and including the Extended Maturity Date, if applicable]* |
| ii. Business Day Convention: | [Floating Rate Convention/Following Business. Day Convention/Modified Following Business. Day Convention/Preceding Business Day Convention/ [*specify other*]] |
| iii. Additional Business Centre(s): | [*Specify*/None ] |
| iv. Manner in which the Rate of Interest | |

| | | |
|---|---|---|
| | and Interest Amount is to be determined: | [Screen Rate Determination/ISDA Determination/*specify other*] |
| v. | Screen Rate Determination | |
| | - Reference Rate: | [ ]<br>(*Either LIBOR, EURIBOR, REIBOR or other, although additional information is required if other*) |
| | - Interest Determination Date(s): | [ ]<br><br>(*Second London Business day prior to the start of each Interest Period if LIBOR (other than Sterling or euro LIBOR),first day of each Interest Period if Sterling LIBOR and the second day on which the TARGET System if EURIBOR or euro LIBOR) and second Reykjavík Business Day of each interest period if REIBOR*<br><br>*[NB: Specify the Interest Determination Date(s) up to and including the Extended Maturity Date, if applicable]* |
| | - Relevant Screen Page: | [ ]<br>(*In the case of EURIBOR, if not Telerate Page 248 ensure it is a page which shows a composite rate or amend the fallback provisions appropriately*) |
| vi. | ISDA Determination: | |
| | - Floating Rate Option: | [ ] |
| | - Designated Maturity: | [ ] |
| | - Reset Date: | [ ] |
| vii. | Margin(s) to Maturity Date: | [+/-] [ ] per cent. per annum |
| viii. | Margin(s) from Maturity Date to Extended Maturity Date: | [+/-] [ ] per cent. per annum |
| ix. | Minimum Rate of Interest: | [[ ] per cent. per annum/Not Applicable] |
| x. | Maximum Rate of Interest: | [[ ] per cent. per annum/Not Applicable] |
| xi. | Day Count Fraction: | [Actual/Actual<br>Actual/365<br>Actual/365 (Fixed)<br>Actual/365 (Sterling)<br>Actual/360<br>30/360<br>30E/360<br>*Other*] |
| xii. | Fallback provisions, rounding provisions and any other terms relating to the method of calculating interest on Floating Rate Covered Bonds, if different from those set out in the Terms and Conditions: | [Applicable/Not Applicable ] |
| xiii. | Maximum Interest Amount: | [Applicable/Not Applicable] |

| | |
|---|---|
| **21. Zero Coupon Covered Bond Provisions:** | [Applicable/Not Applicable]<br>(*If not applicable, delete the remaining subparagraphs of this paragraph*) |

| | |
|---|---|
| i. Accrual Yield: | [ ] per cent. per annum |
| ii. Reference Price: | [ ] |
| iii. Any other formula/basis of determining amount payable: | [ ] |
| iv. Day Count Fraction in relation to Early Redemption Amounts and late payment: | [Conditions 6.8.7.b) and 6.8.11 apply/*specify other*] |

**PROVISIONS RELATING TO REDEMPTION**

| | |
|---|---|
| **22. Issuer Call:** | [Applicable/Not Applicable] (*If not applicable, delete the remaining Subparagraphs of this paragraph*) |
| i. Optional Redemption Date(s): | [ ] |
| ii. Optional Redemption Amount of each Covered Bond and method, if any, of calculation of such amount(s): | [[ ] per Covered Bond of [ ] Specified Denomination] [*specify formula*] [Condition 6.8.7 applies] |
| iii. Early Redemption Amount: | [*As set out in Condition 6.8.7*] |
| iv. If redeemable in part: | |
| (i) Minimum Redemption Amount: | [ ] |
| (ii) Maximum Redemption Amount: | [ ] |
| v. Notice period (if other than as set out in the Terms and Conditions): | [ ] |
| **23. Investor Put:** [Applicable/Not Applicable] | (*If applicable specify details.)* |
| **24. Final Redemption Amount of each Covered Bond:** | [ ] per Covered Bond of [ ] Specified Denomination/*specify other*/see Appendix] [Not Applicable] |
| **25. Early Redemption Amount of each Covered Bond payable on redemption and/or the method of calculating the same (if required or if different from that set out in Condition 6.8.7 (a):** | [ ] |

**GENERAL PROVISIONS APPLICABLE TO THE COVERED BONDS**

| | |
|---|---|
| **26. New Global Covered Bond:** | [Yes/No] |

| | |
|---|---|
| **27. Form of Covered Bonds:** | [VS System Covered Bonds/ISD System Covered Bonds]<br><br>[Bearer Covered Bonds<br><br>Temporary Bearer Global Covered Bond exchangeable for a Permanent Bearer Global Covered Bond which is exchangeable for definitive Covered Bonds [on 60 days' notice given at any time/only after an Exchange Event]]<br><br>[Temporary Bearer Global Covered Bond exchangeable for definitive Covered Bonds on and after the Exchange Date]<br><br>[Permanent Bearer Global Covered Bond exchangeable for definitive Covered Bonds [on 60 days' notice given at any time/only after an Exchange Event]][5]<br><br>[Registered Covered Bond<br><br>Regulation S Global Covered Bonds (U.S.$ [ ] nominal amount) registered in the name of a common depositary for Euroclear and Clearstream, Luxembourg/a common safekeeper for Euroclear and Clearstream, Luxembourg]] |
| **28. Additional Financial Centre(s) or other special provisions relating to Payment Days:** | [Not Applicable/*give details*]<br>(*Note that this item relates to the place of payment and not Interest Period end dates*) |
| **29. Talons for future Coupons or Receipts to be Attached to definitive Covered Bonds** (and dates on which such Talons mature): | [Yes/No. (*If yes, give details)*] |
| **30. Details relating to Partly Paid Covered Bonds:** amount of each payment comprising the Issue Price and date on which each payment is to be made and consequence of failure to pay, including any right of the Issuer to forfeit the Covered Bonds and interest due on late Payment: | [Not Applicable/*give details. N.B. a new form of Temporary Global Covered Bond and/or Permanent Global Covered Bond may be required for Partly Paid issues*] |
| **31. Details relating to Instalment Covered Bonds:** | |
| i. Instalment Amount(s): | [Not Applicable/*give details*] |
| ii. Instalment Date(s): | [Not Applicable/*give details*]<br>Maximum Instalment Amount means, with respect to an Interest Period and a Series of Covered Bonds, the |

[5] **The option to exchange a Temporary or Permanent Global Covered Bond for a Definitive Covered Bond on 60 days' written notice which may be given at any time will only be available to Bondholders where (a) drawdowns are issued in denominations that are a multiple of the minimum denomination traded by Euroclear and Clearstream, Luxembourg or (b) in circumstances where the Bondholder's share is an integral of the minimum denomination traded by Euroclear and Clearstream, Luxembourg*

| | |
|---|---|
| | Relevant Percentage of the aggregate of principal receipts received by the Issuer in respect of assets in the Cover Pool plus amounts in respect of notional principal received from any Swap Provider less amounts payable by the Issuer to any Swap Provider, in each case, converted where applicable into the Specified Currency at the applicable swap rate of exchange; |
| **32. Redenomination applicable:** | Redenomination [not] applicable<br>(*if Redenomination is applicable, specify the applicable Day Count Fraction and any provisions necessary to deal with floating rate interest calculation (including alternative reference rates)*) |
| **33.** i. Swap Provider | [Not applicable/*give details*] |
| ii. Nature of Swap | [Not applicable/*give details*] |
| **34. Other final terms:** | [Not Applicable/*give details*]<br>(*When adding any other final terms consideration should be given as to whether such terms constitute "significant new factors" according to the Commission Delegated Regulation (EU) no. 486/2012 and consequently trigger the need for supplements to the Base Prospectus under Article 16 of the Prospectus Directive.*) |

**DISTRIBUTION**

| | |
|---|---|
| **35.** | |
| i. If syndicated, names of Managers: | [Not Applicable/*give names*] |
| ii. Stabilizing Manager (if any): | [Not Applicable/*give names*] |
| **36. If non-syndicated, name of relevant Dealer** | [ ] |
| **37. Additional selling restrictions:** | [Not Applicable/*give details*] |

**LISTING AND ADMISSION TO TRADING APPLICATION**

These Final Terms comprise the final terms required for the Covered Bonds described herein ***to be admitted to trading*** pursuant to the ISK 100,000,000,000 Covered Bond Programme of Landsbankinn hf. [*Specify other*]

**RESPONSIBILITY**

The Issuer accepts responsibility for the information contained in these Final Terms. [[*Relevant third party information, for example in compliance with Annex XII to the Prospectus Directive in relation to an index or its components*] has been extracted from [specify source].The Issuer confirms that such information has been accurately reproduced and that, so far as it is aware and is able to ascertain from information published by [specify source], no facts have been omitted which would render the reproduced information inaccurate or misleading].

Signed on behalf of the Issuer:

By: ……………………………………………………………………

*Duly authorized*

**PART B – OTHER INFORMATION**

**1. LISTING**

| | | |
|---|---|---|
| i. | Listing: | [Nasdaq OMX Iceland/other (*specify*)/None] |
| ii. | Admission to trading: | [Application has been made for the Covered Bonds to be admitted to trading on [ ] with effect from [ ].] [Not Applicable.] [*specify other*.] |

**2. RATING**

[Not Applicable/The Covered Bonds to be issued have been rated:

[S & P: [•]]
[Moody's: [•]]
[Fitch: [•]]
[*Other*: [•]]

[*Need to include here a brief explanation of the meaning of the ratings if this has previously been published by the rating provider.*](*The above disclosure should reflect the rating allocated to Covered Bonds of the type being issued under the Programme generally or, where the issue has been specifically rated, that rating.*)

**3. NOTIFICATION**

The [*name of competent authority in home Member State*] [has been requested to provide/has provided – *include first alternative for an issue which is contemporaneous with the establishment or update of the Programme and the second alternative for subsequent issues*] the [*names of competent authorities of host Member States*] with a certificate of approval attesting that the Base Prospectus has been drawn up in accordance with the Prospectus Directive.

**4. INTERESTS OF NATURAL AND LEGAL PERSONS INVOLVED IN THE ISSUE**

[Save for any fees payable to the [Managers/Dealer/Advisor], so far as the Issuer is aware, no person involved in the issue of the Covered Bonds has an interest material to the issue. – *Amend as appropriate if there are other interests*]

(*When adding any other description, consideration should be given as to whether such matters described constitute "significant new factors" and consequently trigger the need for a supplement to the Base Prospectus under Article 16 of the Prospectus Directive regulation.*)

**5. USE OF PROCEEDS, ESTIMATED NET PROCEEDS AND TOTAL EXPENSES**

| | | |
|---|---|---|
| i. | Use of proceeds: | [For general funding purposes of the Issuer/*specify other]* |
| ii. | Estimated net proceeds: | [ ] |
| iii. | Estimated total expenses: | [ ] |

**6. YIELD** *(Fixed Rate Covered Bonds Only)*

| | |
|---|---|
| Indication of yield: | [Not Applicable/*specify*]<br>[Note: The yield is calculated at the Issue Date on the basis of the Issue Price. It is not an indication of future yield.] |

**7. HISTORIC INTEREST RATES** *(Floating Rate Covered Bonds Only)*

[Not Applicable/Details of historic [LIBOR/EURIBOR/REIBOR/other] rates can be obtained from [Telerate].]

**8. PERFORMANCE OF CPI, EXPLANATION OF EFFECT ON VALUE OF INVESTMENT AND ASSOCIATED RISKS AND OTHER INFORMATION CONCERNING THE UNDERLYING** *(Inflation Linked Annuity Covered Bonds and Inflation Linked Equal Principal Payment Covered Bonds Only)*

[Need to include details of where past and future performance and volatility of the index/formula can be obtained.]

[[Where the underlying is an index need to include the name of the index and a description if composed by the Issuer and if the index is not composed by the Issuer need to include details of where the information about the index can be obtained.]

[(When completing the above paragraphs, consideration should be given as to whether such matters described constitute "significant new factors" and consequently trigger the need for a supplement to the Base Prospectus under Article 16 of the Prospectus Directive.)]

The Issuer [intends to provide post-issuance information [specify what information will be reported and where it can be obtained]] [does not intend to provide post-issuance information]
(N.B. This paragraph only applies if the Covered Bonds are derivative securities to which Annex XII of the Prospectus Directive Regulation applies.)

**9. OPERATIONAL INFORMATION**

| | | |
|---|---|---|
| i. | ISIN Code: | [ ] |
| ii. | Common Code: | [ ] |
| iii. | Any Clearing system(s) other than Euroclear Bank S.A./N.V. or Clearstream Banking, société anonyme (together with the address of each such clearing system) and the relevant identification number(s): | [Not Applicable/*give name(s) and number(s)*/ISD. The Issuer shall be entitled to obtain certain information from the register maintained by the ISD for the purpose of performing its obligations under the issue of ISD System Covered Bonds. The ISD Agent shall be entitled to obtain such information as is required to perform its duties under the Terms and Conditions of the Covered Bonds and rules and regulations of, and applicable to, the ISD.] |
| iv. | Delivery: | Delivery [against/free of] payment |
| v. | Names and addresses of additional Paying Agent(s) (if any): | [ ] |
| vi. | Intended to be held in a manner which would allow Eurosystem eligibility: | [Yes][No]<br><br>*Note that the designation “yes” simply means that the Covered Bonds are intended upon issue to be deposited* |

*with one of the ICSDs as common safekeeper and does not necessarily mean that the Covered Bonds will be recognised as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem either upon issue or at any or all times during their life. Such recognition will depend upon satisfaction of the Eurosystem eligibility criteria.][include this text if "yes" selected in which case the Covered Bonds must be issued in/NGCBform])*

# 6 TERMS AND CONDITIONS OF THE COVERED BONDS

*The following are the Terms and Conditions of the Covered Bonds which will be incorporated by reference into each Covered Bond (as defined below). The applicable Final Terms in relation to any Tranche of Covered Bonds may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the following Terms and Conditions, replace or modify the following Terms and Conditions for the purpose of such Covered Bonds. Reference should be made to "Form of the Covered Bonds" for a description of the content of Final Terms which will specify which of such terms are to apply in relation to the relevant Covered Bonds.*

The Covered Bonds are bonds issued by Landsbankinn hf. (the **Issuer**) in accordance with the Icelandic Act on Covered Bonds no. 11/2008 (the **Act on Covered Bonds**) and Rules No. 528/2008 on covered bonds (the **Rules**). The Covered Bonds will be issued in compliance with any applicable legal or regulatory restrictions including the rules on foreign exchange issued by the Central Bank of Iceland, and any reference to currencies other than ISK and related expressions shall be construed as taking effect subject to such restrictions being lifted.

This covered bond is one of a Series (as defined below) of Covered Bonds issued by the Issuer.

References herein to the **Covered Bonds** shall be references to the Covered Bonds of this Series and shall include:

(a) in relation to any Covered Bonds represented by a global Covered Bond (a **Global Covered Bond**), units of the lowest denomination specified in the relevant Final Terms (**Specified Denomination**) in the currency specified in the relevant Final Terms (**Specified Currency**);

(b) any definitive Covered Bonds in bearer form (**Bearer Covered Bonds**) issued in exchange for a Global Covered Bond in bearer form; and

(c) any definitive Covered Bonds in registered form (**Registered Covered Bonds**) (whether or not issued in exchange for a Global Covered Bond in registered form); and

(d) any Covered Bonds issued in uncertificated book entry form cleared through the Icelandic Securities Depository or VP Lux (the **VS System Covered Bonds**). VS System Covered Bonds are in dematerialised form. Any references in these Terms and Conditions (the **Conditions)** to Receipts, Coupons and Talons shall not apply to VS System Covered Bonds and no global or definitive Covered Bonds will be issued in respect of VS System Covered Bonds.

Interest bearing definitive Covered Bonds have interest coupons (**Coupons**) and, if indicated in the applicable Final Terms, talons for further Coupons (**Talons**) attached on issue. Any reference herein to Coupons or coupons shall, unless the context otherwise requires, be deemed to include a reference to Talons or talons. Definitive Covered Bonds repayable in instalments have receipts (**Receipts**) for the payment of the instalments of principal (other than the final instalment) attached on issue. Global Covered Bonds do not have Receipts, Coupons or Talons attached on issue.

The Final Terms for this Covered Bond (or the relevant provisions thereof), as set out in Part A of the Final Terms which are (except in the case of VS System Covered Bonds) attached to or endorsed on this Covered Bond, supplement these Conditions and may specify other terms and conditions which shall, to the extent so specified or to the extent inconsistent with the Conditions, replace or modify the Conditions for the purposes of this Covered Bond. References to the **applicable Final Terms** are to Part A of the Final Terms (or the relevant provisions thereof) which are (except in the case of VS System Covered Bonds) attached to or endorsed on this Covered Bond and (in the case of the VS System Covered Bonds) which are deposited with the ISD or VP Lux.

Any reference to **Covered Bondholders** or to **holders** or to **Investor(s)** in relation to any Covered Bonds shall mean (in the case of Bearer Covered Bonds) the holders of the Covered Bonds, (in the case of Registered Covered Bonds) the persons in whose name the Covered Bonds are registered and (in the case of VS Covered Bonds) the persons who are for the time being shown in the records of the ISD or VP Lux as the holders of the Covered Bonds, and shall, in relation to any Covered Bonds represented by a Global Covered Bond and any VS Covered Bonds, be construed as provided below. Any reference herein to **Receiptholders** shall mean the holders of the Receipts and any reference herein to **Couponholders** shall mean the holders of the Coupons and shall, unless the context otherwise requires, include the holders of the Talons.

As used herein, Tranche means Covered Bonds which are identical in all respects (including as to listing and admission to trading on a Regulated Market) and Series means a Tranche of Covered Bonds together with any further Tranche or Tranches of Covered Bonds which are (i) expressed to be consolidated and form a single series and (ii) identical in all respects (including as to listing and admission to trading on a Regulated Market) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices.

Copies of the applicable Final Terms are available for viewing on the Issuer's website, www.landsbankinn.is/sertryggd-skuldabref.

Except where the context otherwise requires, capitalised terms used and not otherwise defined in these Terms and Conditions (including the preceding paragraphs) shall bear the meanings given to them in the applicable Final Terms.

## 6.1 Definitions

*Interpretation:* In these Conditions:

- Covered Bonds and Covered Bondholder shall be deemed to include references to Coupons and Coupon-holders, respectively, where relevant;
- If Talons are specified in the relevant Final Terms as being attached to the Covered Bonds at the time of issue, references to Coupons shall be deemed to include references to Talons;
- If Talons are not specified in the relevant Final Terms as being attached to the Covered Bonds at the time of issue, references to Talons are not applicable;
- Any reference to principal shall be deemed to include Final Redemption Amount, any additional amounts in respect of principal which may be payable under Condition 6.9 (Taxation), any premium payable in respect of a Covered Bond and any other amount in the nature of principal payable pursuant to these Conditions;
- Any reference to interest shall be deemed to include any additional amounts in respect of interest which may be payable under Condition 6.9 (Taxation) and any other amount in the nature of interest payable pursuant to these Conditions;
- If an expression is stated in Condition 6.1 (Definitions) to have the meaning given in the relevant Final Terms, but the relevant Final Terms gives no such meaning or specifies that such expression is "not applicable" then such expression is not applicable to Covered Bonds;
- VS System Covered Bonds are in dematerialised form, and any references in these Terms and Conditions to Coupons and Talons shall not apply to VS System Covered Bonds and no global or definitive Covered Bonds will be issued in respect thereof;
- If the Covered Bonds are Zero Coupon Covered Bonds, references to Coupons and Couponholders are not applicable; and
- Where the word "including" appears in these Conditions the words "without limitation" shall be deemed to be inserted immediately afterwards.

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| **Accrual Period** | In accordance with Condition 6.6.7(c)(i), the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date. |
| **Accrual Yield** | In relation to a Zero Coupon Covered Bond, the meaning given in the applicable Final Terms. |
| **Act on Covered Bonds** | The Icelandic Act on Covered Bonds No. 11/2008 which came into effect 4 March 2008, as amended (*Ice. "Lög um sértryggð skuldabréf nr. 11/2008"*). |
| **Act on Securities Transactions** | The Icelandic Act on Securities Transactions No. 108/2007 which came into effect 1 November 2007, as amended (*Ice. "Lög um verðbréfaviðskipti 108/2007"*). |

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| **Additional Business Centre** | The meaning (if any) given in the applicable Final Terms. |
| **Additional Financial Centre** | The meaning (if any) given in the applicable Final Terms. |
| **Agency Agreement** | Shall mean the agency agreement (if any) to be entered into between the Issuer, Fiscal Agent and other agents. |
| **Amortised Face Amount** | The meaning given in Condition 6.8.7(b). |
| **Annuity Amount** | The meaning given in Condition 6.7.1(a). |
| **Annuity Covered Bonds** | Covered Bonds which will be redeemed in Annuity Amounts (subject to adjustment for indexation in accordance with the provisions specified in the applicable Final Terms) on one or more Interest Payment Dates as specified in the applicable Final Terms. |
| **Automatic Extension** | The meaning given in Condition 6.8.12(b). |
| **Bearer Covered Bond** | Means Cover Bonds issued in bearer form. |
| **Business Day** | As defined in Condition 6.6.7(a). |
| **Business Day Convention** | In respect of a Tranche of Covered Bonds and either the Specified Periods or the Interest Payments Dates, the business day convention specified in the applicable Final Terms and determined in accordance with Conditions 6.6.7(b). |
| **Calculation Agent** | The meaning (if any) given in the applicable Final Terms. |
| **Clearstream, Luxembourg** | Clearstream Banking, société anonyme, 42 Avenue JF KennedyL-1855,Luxembourg, or its successors. |
| **Common Safekeeper** | The common safekeeper for Euroclear and Clearstream Luxembourg. |
| **CPI** | The consumer price indexation, as calculated by Statistics Iceland in accordance with the Act on Price Indexation No. 12/1995 (*Ice.* "*Lög um vísitölu neysluverðs nr. 12/1995"*) and published monthly in the Legal Gazette (*Ice. "Lögbirtingablaðið"*) in Iceland. |
| **Couponholders** | The holders of the Coupons (which expression shall, unless the context otherwise requires, include the holders of the Talons). |
| **Coupons** | Interest coupons expressing the amount payable by way of interest in respect of definitive Covered Bonds. |
| **Cover Pool** | A collection of bonds, substitute collateral and other assets listed in the Register, as provided for in Chapter VI of the Act on Covered Bonds, over which the Covered Bondholders and Issuer's counterparties have rights of priority pursuant to the provisions of the Act on Covered Bonds. |
| **Cover Pool Member States** | A state which is a party to the Agreement on the European Economic Area or the European Free Trade Association Treaty, or |

the Faroe Islands.

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| **Covered Bond** | The covered bonds issued or to be issued by the Issuer under the Programme in accordance with the Act on Covered Bonds. |
| **Covered Bondholders** | The holders for the time being of the Covered Bonds. |
| **Covered Bond Legislation** | Act on Securities Transactions, Act on Covered Bonds, any relevant executive orders and appurtenant regulations as may be supplemented, amended, modified or varied from time to time (as well as any judicial decisions and administrative pronouncements, all of which are subject to change, including with retroactive effect). |
| **Cover Pool Swap Agreement** | Means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Cover Pool Swap entered into from time to time between the Issuer and the Cover Pool Swap Provider. |
| **Cover Pool Swap Provider** | Means the third party counterparties in their respective capacities as cover pool swap provider under a Cover Pool Swap Agreement. |
| **Cover Pool Swap** | Means the Cover Pool Swap which enables the Issuer to convert ISK interest payments (less a client margin) received by the Issuer in respect of assets (other than Swaps) registered to the Cover Pool into floating or fixed payments (as the case may be) payments linked to the interest rate payable on the Covered Bonds. |
| **Currency Swap Agreement** | Means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Currency Swap(s) entered into from time to time between the Issuer and each Currency Swap Provider. |
| **Currency Swap Provider** | Means the third party counterparties in their respective capacities as currency swap provider under a Currency Swap Agreement. |
| **Currency Swap** | Means each currency swap which enables the Issuer to hedge currency risks arising from (a) Covered Bonds which are issued in currencies other than ISK and (b) assets (other than Mortgage Bonds) which are registered to the Cover Pool and are denominated in currencies other than ISK. |
| **Dealer** | Any dealer appointed by the Issuer (if any). |
| **Designated Account** | Means the account maintained by a holder with a Designated Bank and identified as such in the Registered Covered Bond Register. |
| **Designated Bank** | Means (in the case of payment in a Specified Currency other than euro) a bank in the principal financial centre of the country of such Specified Currency and (in the case of a payment in euro) any bank which processes payments in euro. |
| **Designated Maturity** | The meaning given in the ISDA Definitions. |

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| **Determination Date** | The meaning given in the applicable Final Terms. |
| **Determination Period** | The meaning given in Condition 6.6.7(d). |
| **Directors** | The directors for the time being of the Issuer as defined in the Icelandic Act No. 2/1995, on Limited Liability Companies (*Ice. "Lög um hlutafélög nr. 2/1995"*). |
| **Distribution Compliance Period** | The period that ends 40 days after completion of the distribution of each Tranche of Covered Bonds, as certified by the relevant Dealer. |
| **Early Redemption Amount** | The amount calculated in accordance with Condition 6.8.7. |
| **Equal Payment Amount** | The meaning given in Condition 6.7.1(b). |
| **EU** | The European Union. |
| **EURIBOR** | Euro-zone inter-bank offered rate. |
| **Euroclear** | Euroclear Bank S.A./N.V., 1, Boulevard du Roi Albert II B - 1210 Brussels, or its successor. |
| **Extended Maturity Date** | Means the date to which the payment of the Final Redemption Amount is deferred if not paid at the Maturity Date as further outlined in Condition 6.8.12. |
| **Final Redemption Amount** | The meaning given in the applicable Final Terms. |
| **Final Terms** | Each Tranche will be the subject to the Final Terms which, for the purposes of that Tranche only, completes the Terms and Conditions of the Covered Bonds and this Base Prospectus and must be read in conjunction with this Base Prospectus. The terms and conditions applicable to any particular Tranche of Covered Bonds are the Terms and Conditions of the Covered Bonds as completed, amended and/or replaced by the relevant Final Terms. |
| **Fiscal Agent** | Landsbankinn hf., or any successor agent appointed as such. |
| **Fixed Rate Covered Bonds** | Covered Bonds that pay a fixed rate of interest on such date or dates as may be agreed between the Issuer and the relevant Dealer as specified in the applicable Final Terms and on redemption calculated on the basis of such Day Count Fraction as may be agreed between the Issuer and the relevant Dealer. |
| **Floating Rate** | The meaning given in the ISDA Definitions. |
| **Floating Rate Convention** | The meaning given in Condition 6.6.7(b)(i). |
| **Floating Rate Covered Bonds** | Covered Bonds which bear interest at a rate determined:<br>(i) on the same basis as the floating rate under a notional interest rate swap transaction in the relevant Specified Currency governed by an agreement incorporating the ISDA Definitions; or |

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| | (ii) on the basis of a r eference rate appearing on the agreed screen page of a commercial quotation service; or<br>(iii) on such other basis as may be agreed between the Issuer and the relevant Dealer, or as set out in the applicable Final Terms. |
| **FME** | The Financial Supervisory Authority, Iceland (*Ice. "Fjármálaeftirlitið"*). |
| **Following Business Day Convention** | The meaning given in Condition 6.6.7(b)(ii). |
| **Global Covered Bonds** | Global Covered Bonds comprising Temporary Global Covered Bonds and Permanent Global Covered Bonds. |
| **Government Bond** | Bonds granted to or guaranteed by certain governmental bodies., in accordance with Article 5 of the Act on Covered Bonds. |
| **Group** | The Issuer and its Subsidiaries. |
| **IFRS** | International Financial Reporting Standards. |
| **Indexed Currency Swap Agreement** | Means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Indexed Currency Swap(s) entered into from time to time between the Issuer and each Indexed Currency Swap Provider. |
| **Indexed Currency Swap Provider** | Means the third party counterparties in their respective capacities as indexed currency swap provider under an Indexed Currency Swap Agreement. |
| **Indexed Currency Swap** | Means each currency swap which enables the Issuer to hedge currency and inflation risks arising from (i) Covered Bonds which are issued in currencies other than ISK and not indexed linked and (ii) assets which are registered to the Cover Pool and are denominated in ISK and indexed linked. |
| **Interest Rate Swap Agreement** | Means the ISDA Master Agreement, schedule and confirmation(s) (as amended and supplemented from time to time) relating to the Interest Rate Swap(s) entered into from time to time between the Issuer and each Interest Rate Swap Provider. |
| **Inflation Linked Annuity Covered Bonds** | Covered Bonds that pay an Annuity Amount on such date or dates as decided by the Issuer and set out in the Final Terms. |
| **Inflation Linked Equal Principal Payment Covered Bonds** | Covered Bonds that pay an Equal Payment Amount on such date or dates as decided by the Issuer and set out in the Final Terms. |
| **Instalment Amounts** | In respect of Instalment Covered Bonds, each amount specified as such in the applicable Final Terms. |
| **Instalment Covered Bonds** | Covered Bonds which will be redeemed in Instalment Amounts and on the Instalment Dates specified in the applicable Final Terms. |
| **Instalment Dates** | In respect of Instalment Covered Bonds, each date specified as such in the applicable Final Terms. |

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| **Interest Amount** | The amount of interest payable on the Floating Rate Covered Bonds in respect of each Specified Denomination for the relevant Interest Period, as calculated in accordance with Condition 6.6.4(d) or the amount of interest payable on Inflation Linked Annuity Covered Bonds or Inflation Linked Equal Payment Covered Bonds in respect of each Specified Denomination for the relevant Interest Period, as calculated in accordance with Conditions 6.6.1 and 6.6.2 respectively. |
| **Interest Commencement Date** | In the case of interest-bearing Covered Bonds, the date specified in the applicable Final Terms from (and including) which interest will accrue in respect of the relevant Covered Bonds. |
| **Interest Determination Date** | In respect of Floating Rate Covered Bonds to which Screen Rate Determination is applicable, the meaning given in the applicable Final Terms. |
| **Interest Payment Date** | In respect of Fixed Rate Covered Bonds, Inflation Linked Annuity Covered Bonds and Inflation Linked Equal Payment Covered Bonds, the meaning given in the applicable Final Terms and in respect of Floating Rate Covered Bonds the meaning given in Condition 6.6.4(a). |
| **Interest Period** | In accordance with Condition 6.6.7(e) the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date. |
| **Investor** | The holders for the time being of the Covered Bonds. |
| **Investor's Currency** | The currency or currency unit that an investor's financial activities are denominated in, other than the Specified Currency. |
| **Investor Put** | If specified as applicable in the applicable Final Terms, the provision by which the Investor may redeem a Series of Covered Bonds in accordance with Condition 6.8.4. |
| **ISD** | The Icelandic Securities Depositary hf. Reg.No. 500797-3209, with its registered office at Laugavegur 182, 105 Reykjavík (*Ice. "Verðbréfaskráning Íslands"*). |
| **ISD system account operator** | Landsbankinn hf. in its capacity as ISD system account operator. |
| **ISD System Covered Bonds** | Shall mean Covered Bonds issued in a dematerialised, uncertified book entry form cleared through ISD. |
| **ISDA** | International Swaps and Derivatives Association, Inc. |
| **ISDA Definitions** | The meaning given in Condition 6.6.4(b). |
| **ISDA Determination** | If specified as applicable in the applicable Final Terms Document, the manner in which the Rate of Interest on Floating Rate Covered Bonds is to be determined in accordance with Condition 6.6.4(b). |

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| **ISDA Rate** | The meaning given in Condition 6.6.4(b). |
| **ISK or Icelandic Krona or krónur** | The lawful currency of the Republic of Iceland. |
| **Issue Date** | Each date on which the Issuer issues a Tranche of Covered Bonds under the Programme, as specified in the applicable Final Terms. |
| **Issue Price** | The price, generally expressed as a p ercentage of the nominal amount of the Covered Bonds, at which a T ranche of Covered Bonds will be issued. |
| **Issuer** | Landsbankinn hf., Reg.No. 471008-0280, having its registered office at Austurstræti 11, 155 Reykjavík, Iceland. |
| **Issuer Call** | If specified as applicable in the applicable Final Terms, the provision by which the Issuer may redeem a S eries of Covered Bonds in accordance with Condition 6.8.3. |
| **Landsbankinn** | Landsbankinn hf., Reg.No. 471008-0280, having its registered office at Austurstræti 11, 155 Reykjavík, Iceland. |
| **LIBOR** | London inter-bank offered rate |
| **Margin** | As specified in the applicable Final Terms (if any). |
| **Maturity Date** | As specified in the applicable Final Terms. |
| **Maximum Rate of Interest** | In respect of a Floating Rate Covered Bond, the percentage rate per annum (if any) specified in the applicable Final Terms. |
| **Maximum Redemption Amount** | The amount specified as such in the applicable Final Terms. |
| **Member State** | A state which is a member of the European Economic Area. |
| **Minimum Rate of Interest** | In respect of Floating Rate Covered Bonds, the percentage rate per annum (if any) specified in the applicable Final Terms. |
| **Minimum Redemption Amount** | The amount specified as such in the applicable Final Terms. |
| **Modified Following Business Day Convention** | The meaning given in Condition 6.6.7(b)(iii). |
| **Mortgage** | Each mortgage loan referenced by its mortgage loan identifier number and comprising the aggregate of all principal sums, interest, costs, charges, expenses and other moneys due or owing with respect to that mortgage loan under the relevant mortgage terms by a borrower to the Issuer on the security of a Mortgage from time to time outstanding or, as the context may require, the borrower's obligations in respect of the same, and eligible to be added to the Cover Pool. |
| **Nasdaq OMX Iceland** | The main market of NASDAQ OMX Iceland hf., Reg.No. 681298-2829, with its registered office at Laugavegur 182, 105 Reykjavík. |

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| **Optional Redemption Amount** | The meaning (if any) given in the applicable Final Terms. |
| **Optional Redemption Date** | The meaning (if any) given in the applicable Final Terms. |
| **Overcollateralization** | The percentage by which the Value will exceed the nominal value of the liabilities, relating to the issued Covered Bonds, along with all accrued interests**.** |
| **Partial Redemption** | The meaning given in Condition 6.8.12(f). |
| **Paying Agents** | The Principal Paying Agent and any other paying agent appointed (if any). |
| **Payment Day** | The meaning given in Condition 6.7.8. |
| **Preceding Business Day Convention** | The meaning given in Condition 6.6.7(b)(iv). |
| **Principal Amount Outstanding** | In accordance with Condition 6.6.7(f) means in respect of a Covered Bond, except an Inflation Linked Annuity Covered Bond and an Inflation Linked Equal Principal Payment Covered Bond on any day, the principal amount of that Covered Bond on the relevant Issue Date thereof less principal amounts received by the relevant Covered Bondholder in respect thereof on or prior to that day and in respect of an Inflation Linked Annuity Covered Bond and an Inflation Linked Equal Payment Covered Bond, the meaning given in the applicable Final Terms. |
| **Principal Paying Agent** | The Issuer, Landsbankinn hf. |
| **Programme** | ISK 100,000,000,000 (or its equivalence in other currencies calculated as described herein) covered bond programme established by the Issuer on the Issue Date which shall in the beginning not exceed a l imit of ISK 10,000,000,000. Any increases of the Programme shall be subject to the FME approval. |
| **Prospectus Directive** | Directive 2003/71/EC (*Ice. "Tilskipun Evrópuþingsins og Ráðsins 2003/71/EB"*) as amended (which includes the amendments made by Directive 2010/73/EU). |
| **Rate of Interest** | In respect of a Series of interest-bearing Covered Bonds, the rate of interest payable from time to time in respect of such Covered Bonds determined in accordance with the Terms and Conditions and the applicable Final Terms. |
| **Receiptholders** | The holders of Receipts (which expression shall, unless the context otherwise requires, include the holders of the Talons). |
| **Redeemed Covered Bonds** | The meaning given in Condition 6.8.3. |
| **Reference Price** | In respect of a Zero Coupon Covered Bond, the meaning given in the applicable Final Terms. |
| **Reference Rate** | In respect of Floating Rate Covered Bonds to which Screen Rate Determination applies, the meaning given in the applicable Final |

Terms.

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| **Registrar** | Any registrar to be appointed in accordance with an Agency Agreement. |
| **Register** | A special register in respect of Covered Bonds and the Cover Pool, together with any derivative agreements that an issuer must maintain in accordance with Chapter VI of the Act on Covered Bonds and Chapter VI of the Rules. |
| **Registered Covered Bond Register** | Register of holders of the Registered Covered Bonds maintained by the Registrar. |
| **Registered Covered Bond** | Means Covered Bonds issued in registered form. |
| **Regulated Market** | Means a medium for the exchange of goods or services over which a government body exerts a level of control. |
| **Regulation S** | Regulation S under the US Securities Act. |
| **Regulation S Global Covered Bonds** | Global covered bonds offered and sold in reliance on Regulation S. |
| **REIBOR** | Reykjavík Inter Bank Offered Rate. |
| **Relevant Screen Page** | In respect of Floating Rate Covered Bonds to which Screen Rate Determination applies, the meaning given in the Final Terms. |
| **Relevant Subsidiary** | Means any Subsidiary other than (i) a Subsidiary acquired, formed or operated in relation to the merger and acquisitions services provided to a customer of the Issuer for the purpose of completing a transaction or restructuring a company or (ii) any Subsidiary acquired or formed as a result of the Issuer's foreclosure activities in relation to its general banking business. |
| **Reset Date** | The Meaning given in the ISDA Definitions. |
| **Rules** | The rules of 3 June 2008 No. 528/2008 on Covered Bonds issued by the FME under the authority conferred on it by Article 25 of the Act on Covered Bonds, which came into effect 3 June 2008, as amended. |
| **Screen Rate Determination** | If specified as applicable in the applicable Final Terms, the manner in which the Rate of Interest on Floating Rate Covered Bonds is to be determined in accordance with Condition 6.6.4(b). |
| **Security Interest** | The meaning given in Condition 6.4.1. |
| **Selection Date** | The meaning given in Condition 6.8.3. |
| **Senior Debt** | Means loans that may be taken out to purchase assets which are in turn added to the Cover Pool in the event that the Issuer is required to post additional collateral. |
| **Series** | A Tranche of Covered Bonds together with any further Tranche or Tranches of Covered Bonds which are (i) expressed to be |

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| | consolidated and form a single series and (ii) identical in all respects (including as to listing and admission to trading) except for their respective Issue Dates, Interest Commencement Dates and/or Issue Prices. |
| **Specified Currency** | Subject to any applicable legal or regulatory restrictions, euro, Sterling, U.S. Dollars and such other currency or currencies as may be agreed from time to time by the Issuer, the relevant Dealer and the Principal Paying Agent and specified in the applicable Final Terms. |
| **Specified Denomination** | In respect of a Series of Covered Bonds, the denomination or denominations of such Covered Bonds at the minimum amount of EUR 100,000 as specified in the applicable Final Terms. |
| **Specified Interest Payment Date** | In respect of Floating Rate Covered Bonds, the meaning (if any) given in the applicable Final Terms. |
| **Subsidiary** | Means an entity from time to time of which the Issuer (i) has direct or indirect control or (ii) owns directly or indirectly more than 50 per cent. of the share capital or similar ownership; "control" for this purpose means the power to direct the management and the policies of the entity, whether through the ownership of voting capital, by contract or otherwise. |
| **Sub-Unit** | The meaning given in Condition 6.6.7(g). |
| **Swap Provider** | Means the Cover Pool Swap Provider, each Currency Swap Provider and each Interest Rate Swap Provider. |
| **Talons** | Talons for further Coupons in respect of interest-bearing definitive Covered Bonds. |
| **TARGET System** | The meaning given in Condition 6.6.7(a). |
| **Temporary Bearer Global Covered Bond** | The temporary global Covered Bond in bearer form which will initially represent the Bearer Covered Bond of each Tranche. |
| **Terms and Conditions or Conditions** | The terms and conditions of the Covered Bonds. |
| **Tranche** | An issue of Covered Bonds which are identical in all respects (including as to listing and admission to trading). |
| **Transfer Agent** | Landsbankinn hf., or any successor agent appointed as such. |
| **US Securities Act** | U.S. Securities Act of 1933, as amended. |
| **Value** | The nominal par value of the Cover Pool along with all accrued interest (but excluding the nominal par value of each Mortgage within the Cover Pool which is in arrears for 90 days or longer at the relevant time). |
| **VS System Covered Bonds** | Means Covered Bonds issued in uncertificated book entry form cleared through the ISD or VP Lux and/or, in relation to any Tranche of Covered Bonds, any other clearing system as may be |

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| | specified in the relevant Final Terms (as the case may be). |
| **VP LUX** | Means VP Lux S.à.r.l., 32, Boulevard Royal, L-2449 Luxembourg, or its successors. |
| **Zero Coupon Covered Bonds** | Covered Bonds which will be offered and sold at a discount to their nominal amount and which will not bear interest. |
| **€, Euro, EUR** or **euro** | The currency of the European economic monetary union. |
| **£** or **Sterling** | The lawful currency for the time being of the United Kingdom of Great Britain and Northern Ireland. |
| **$, U.S.$, U.S. Dollars, US Dollars or USD** | The lawful currency for the time being of the United States of America. |

## 6.2 Form, Denomination and Title

***Form of the Covered Bonds**:* The Covered Bonds will be issued in bearer form (the Bearer Covered Bonds), registered form (the Registered Covered Bonds), or, in the case of VS System Covered Bonds, uncertificated book entry form, as specified in the applicable Final Terms and, in the case of definitive Covered Bonds, serially numbered, in the Specified Currency and the Specified Denomination(s). The Covered Bonds will be in the Specified Currency and the Specified Denomination(s). Covered Bonds of one Specified Denomination may not be exchanged for Covered Bonds of another Specified Denomination.

The Covered Bonds may take the form of an Inflation Linked Annuity Covered Bond, an Inflation Linked Equal Principal Payment Covered Bond, a Fixed Rate Covered Bond, a Floating Rate Covered Bond, a Zero Coupon Covered Bond or a combination of any of the foregoing, depending upon the Interest Basis and Redemption/Payment Basis shown in the applicable Final Terms.

**Bearer Covered Bonds**

Each Tranche of Covered Bonds issued in the form of Bearer Covered Bonds will initially be represented by a Temporary Bearer Global Covered Bond or, if so specified in the applicable Final Terms, a Permanent Bearer Global Covered Bond without Coupons, Receipts or Talons which will:

(i) if the Global Covered Bonds are intended to be issued in a new global covered bond form ("NGCB"), as specified in the applicable Final Terms, be delivered on or prior to the original issue date of the Tranche to a Common Safekeeper; and

(ii) if the global Covered Bonds are not intended to be issued in NGCB form, be delivered on or prior to the original issue date of the Tranche to a Common Depositary.

Interests in the Temporary Bearer Global Covered Bond will be exchanged either for interests in a Permanent Bearer Global Covered Bond or, where specified in the applicable Final Terms (subject to such notice period as is specified in the Final Terms), for definitive Bearer Covered Bonds on or after the date (the "Exchange Date") which is the later of (i) 60 days after the Temporary Bearer Global Covered Bond is issued and (ii) 60 days after completion of the distribution of the relevant Tranche, as certified by the relevant Dealer (in the case of a non-syndicated issue) or the relevant lead manager (in the case of a syndicated issue). Such exchange will be made only upon delivery of written certification to Euroclear and/or Clearstream, Luxembourg, as the case may be, to the effect that the beneficial owner of such Covered Bonds is not a U.S. person or other person who has purchased such Covered Bonds for resale to, or on behalf of, U.S. persons and Euroclear and/or Clearstream, Luxembourg, as the case may be, and has given a like certification (based on the certification it has received) to the Fiscal Agent.

If an interest or principal payment date for any Covered Bonds occurs whilst such Covered Bonds are represented by a Temporary Bearer Global Covered Bond, the related interest or principal payment will be made only to the extent that certification of non-U.S. beneficial ownership has been received as described in the last sentence of the immediately preceding paragraph unless such certification has already been given. The holder of a Temporary Bearer Global Covered Bond will not be entitled to collect any payment of interest or principal due on or after the Exchange Date unless, upon due certification, exchange of the Temporary Bearer Global Covered Bond is improperly withheld or refused. Payment of principal or interest (if any) on a Permanent Bearer Global Covered Bond will be made through Euroclear or Clearstream, Luxembourg (against presentation or surrender, as the case may be, of the Permanent Bearer Global Covered Bond if the Permanent Bearer Global Covered Bond is not intended to be issued in NGCB form) without any further requirement for certification. Pursuant to the Agency Agreement the Fiscal Agent shall arrange that, where a further Tranche of Covered Bonds is issued, the Covered Bonds of such Tranche shall be assigned a common code and ISIN by Euroclear and Clearstream, Luxembourg which are different from the common code and ISIN assigned to Covered Bonds of any other Tranche of the same Series until at least expiry of the Distribution Compliance Period applicable to the Covered Bonds of such Tranche.

The applicable Final Terms will specify that either (i) a Permanent Bearer Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for definitive Bearer Covered Bonds with, where applicable, Receipts, Coupons and Talons attached upon not less than 60 days' written notice from Euroclear and (or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Bearer Global Covered Bond) to the Fiscal Agent as described therein or (ii) a Permanent Bearer Global Covered Bond will be exchangeable (free of charge), in whole but not in part, for definitive Bearer Covered Bonds with, where applicable, Receipts, Coupons and Talons attached only upon the occurrence of an Exchange Event as described therein. "Exchange Event" means (i) the Issuer has been notified that either Euroclear or Clearstream, Luxembourg has been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or otherwise) or has announced an intention permanently to cease business or has in fact done so and no alternative clearing system satisfactory to the Issuer, the Fiscal Agent, the other Paying Agents and the Covered Bondholders is available or, unless otherwise specified in the applicable Final Terms, (ii) the Issuer has or will become obliged to pay additional amounts as provided for or referred to in Condition 6.9 (Taxation) which would not be required were the Covered Bonds represented by the Permanent Bearer Global Covered Bond in definitive bearer form and a certificate to such effect signed by two Directors has been given to the Fiscal Agent. The Issuer will promptly give notice to Covered Bondholders in accordance with Condition 6.11 (Notices) if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg (acting on the instructions of any holder of an interest in such Permanent Bearer Global Covered Bond) or the Covered Bondholders may give notice to the Fiscal Agent requesting exchange and in the event of the occurrence of an Exchange Event as described in (ii) above, the Issuer may also give notice to the Fiscal Agent and the Covered Bondholders requesting exchange. Any such exchange shall occur not later than 30 days after the date of receipt of the first relevant notice by the Fiscal Agent.

The following legend will appear on all Bearer Covered Bonds, Coupons, Receipts and Talons which have an original maturity of more than 365 days:

**"ANY UNITED STATES PERSON WHO HOLDS THIS OBLIGATION WILL BE SUBJECT TO LIMITATIONS UNDER THE UNITED STATES INCOME TAX LAWS INCLUDING THE LIMITATIONS PROVIDED IN SECTIONS 165(j) AND 1287 (a) OF THE INTERNAL REVENUE CODE.“**

The sections referred to provide that United States holders, with certain exceptions, will not be entitled to deduct any loss on bearer Covered Bonds, receipts or interest coupons and will not be entitled to capital gains treatment of any gain on any sale, disposition, redemption or payment of principal in respect of Bearer Covered Bonds, Receipts or Coupons.

**Registered Covered Bonds**

Unless otherwise provided with respect to a p articular Series of Registered Covered Bonds, the Registered Covered Bonds of each Tranche of such Series offered and sold in reliance on Regulation S, which will be sold to non-U.S. persons outside the United States, will initially be represented by a Regulation S Global Covered Bond which will be deposited with a custodian for, and registered in the name of a nominee of, a Depository Trust Company (the "DTC") or Common Safekeeper as the case may be for the accounts of Euroclear and Clearstream, Luxembourg. Prior to expiry of the Distribution compliance Period applicable to each Tranche of Covered Bond, beneficial interests in a Regulation S Global Covered Bond may not be offered or sold to, or for the account or benefit of, a U.S. person save as otherwise provided in Condition 6.2 (Form, Denomination and Title) and may not be held otherwise than through Euroclear or Clearstream, Luxembourg and such Regulation S Global Covered Bond will bear a legend regarding such restrictions on transfer.

Registered Covered Bonds of each Tranche of such Series may only be offered and sold in the United States or to U.S. persons in private transactions to Qualified Institutional Buyers ("QIB"). The Registered Covered Bonds of each Tranche sold to QIBs will be represented by a Restricted Global Covered Bond which will be deposited with a custodian for, and registered in the name of a nominee of, DTC.

Persons holding beneficial interests in Registered Global Covered Bonds will be entitled or required, as the case may be, under the circumstances described below, to receive physical delivery of definitive Covered Bonds in fully registered form.

Payments of principal on the Registered Covered Bonds will be made on the relevant payment date to the persons shown on the Registered Covered Bond Register at the close of business on the business day (being for this purpose a day on which banks are open for business in Brussels) immediately prior to the relevant payment date. Payments of interest on the Registered Covered Bonds will be made on the relevant payment date to the person in whose name such Covered Bonds, Receipts and Coupons immediately preceding such payment date.

Payments of the principal of, and interest (if any) on, the Registered Global Covered Bonds will be made to the nominee of DTC as the registered holder of the Registered Global Covered Bonds. None of the Issuer, any Paying Agent and the Registrar will have any responsibility or liability for any aspect of the records relating to or payments made on account of beneficial ownership interests in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

Interests in a Registered Global Covered Bonds will be exchangeable (free of charge), in whole but not in part, for definitive Registered Covered Bonds without receipts, coupons or talons attached only upon the occurrence of an Exchange Event. For these purposes, Exchange Event means that (i) in the case of Covered Bonds registered in the name of a nominee for a Common Depositary the Issuer has been notified that both Euroclear and Clearstream, Luxembourg have been closed for business for a continuous period of 14 days (other than by reason of holiday, statutory or such case, no successor clearing system is available) or (ii) has or will become subject to adverse conditions for the trading of Global Covered Bonds in definitive form. The Issuer will promptly give notice to Covered Bondholders in accordance with Condition 6.11 (Notices) if an Exchange Event occurs. In the event of the occurrence of an Exchange Event, Euroclear and/or Clearstream, Luxembourg or any person acting on their behalf (acting on the instructions of any holder of an interest in such Registered Global Covered Bond) may give notice to the Registrar requesting such exchange and, in the event of the occurrence of an Exchange Event as described in (ii) above, the Issuer may also give notice to the Registrar requesting exchange. Any such exchange shall occur not later than 10 days after the date of receipt of the first relevant notice by the Registrar.

**Transfer of Interest**

For so long as any of the Covered Bonds are represented by a Bearer Global Covered Bond held by Euroclear and/or Clearstream, Luxembourg, or so long as DTC or its nominee is the registered holder of a Registered Global Covered Bond or so long as the Covered Bond is a VS Systems Covered Bond, each person who is for the time being shown in the records of Euroclear and/or Clearstream, Luxembourg, DTC, the ISD or VP Lux, as the case may be, as the holder of a particular nominal amount of such Covered Bonds (in which regard any certificate or other document issued by Euroclear, Clearstream, Luxembourg, DTC or its nominee, the ISD or VP Lux as to the nominal amount of such Covered Bonds standing to the account of any person shall be conclusive and binding for all purposes save in the case of manifest error) shall be treated by the Issuer, the Fiscal Agent and any other Paying Agent as the holder of such nominal amount of such Covered Bonds for all purposes other than (in the case only of Covered Bonds not being VS System Covered Bonds) with respect to the payment of principal or interest on the Covered Bonds, for which purpose, in the case of Covered Bonds represented by a Bearer Global Covered Bond, the bearer of the relevant Global Bearer Covered Bond, or in the case of Covered Bonds where DTC or its nominee is the registered holder of a Registered Global Covered Bond, DTC or its nominee shall be treated by the Issuer, the Fiscal Agent and any other Paying Agent as the holder of such Covered Bonds in accordance with and subject to the terms of the relevant global Covered Bond (and the expressions “Covered Bondholder” and “holder of Covered Bonds” and related expressions shall be construed accordingly).

Covered Bonds which are represented by a Bearer Global Covered Bond will only be transferable in accordance with the rules and procedures for the time being of Euroclear or Clearstream, Luxembourg.

Interests in a Registered Global Covered Bond may, subject to compliance with all applicable restrictions, be transferred to a person who wishes to hold such interest in another Registered Global Covered Bonds. No beneficial owner of an interest in a Registered Global Covered Bond will be able to exchange or transfer such interest, except in accordance with the applicable procedures of DTC, Euroclear and Clearstream, Luxembourg, in each case to the extent applicable. Transfers of beneficial interests in Registered Global Covered Bonds will be effected by Euroclear or Clearstream, Luxembourg, as the case may be, and, in turn, by other participants and, if appropriate, indirect participants in such clearing systems acting on behalf of transferors and transferees of such interests. A beneficial interest in a Registered Global Covered Bond will, subject to compliance with all applicable legal and regulatory restrictions, be transferable for Covered Bonds in definitive form or for a beneficial interest in another Registered Global Covered Bond only in the authorised denominations set out in the applicable Final Terms and only in accordance with the rules and operating procedures for the time being of Euroclear or Clearstream, Luxembourg, as the case may be, and in accordance with the terms and conditions specified in the Agency Agreement. Registered Covered Bonds are also subject to the restrictions on transfer set forth therein and will bear a legend regarding such restrictions.

A Registered Covered Bond in definitive form may be transferred in whole or in part (in the authorised denominations set out in the applicable Final Terms). In order to effect any such transfer (a) the holder or holders thereof must (i) surrender the Registered Covered Bond for registration of the transfer of the Registered Covered Bond (or the relevant part of the Registered Covered Bond) at the specified office of any Transfer Agent, with the form of transfer thereof in writing and (ii) complete and deposit such other certification as may be required by the relevant Transfer Agent (if any) and (b) the relevant Transfer Agent (if any) must, after due and careful enquiry, be satisfied with the documents of title and the identity of the person making the request. Subject as provided above, the relevant Transfer Agent (if any) has agreed within three business days (being for this purpose a day on which banks are open for business in the city where the specified office of the relevant Transfer Agent (if any) is located) of the request (or such longer period as may be required to comply with any applicable fiscal or other laws or regulations), authenticate and deliver, or procure the authentication and delivery of, at its specified office as the relevant transferee may request, a new Registered Covered Bond in definitive form in respect of the balance of the Registered Covered Bond not transferred will be so authenticated and delivered or (at the risk of the transferor) sent to the transferor.

Prior to expiry of the applicable Distribution Compliance Period, transfers by the holder of, or of a beneficial interest in, a Regulation S Global Covered Bond to a transferee in the United States or who is a U.S. person will only be made upon receipt by the Registrar of a written certification substantially in the form set out in the Agency Agreement, amended as appropriate, copies of which are available from the specified office of any Transfer Agent (if any), from the transferor of the Covered Bond or beneficial interest therein to the effect that such transfer is being made pursuant to the Securities Act or an exemption therefrom, subject to receipt by the Issuer of such satisfactory evidence as the Issuer may reasonably require, which may include an opinion of U.S. counsel, that such transfer is in compliance with any applicable securities laws of any State of the United States, and, in each case, in accordance with any applicable securities laws of any State of the United States or any other jurisdiction.

Each Tranche of VS System Covered Bonds will be issued in uncertificated and dematerialised book entry form. Legal title to the VS Systems Covered Bonds will be evidenced by book entries in the records of ISD or VP LUX. Title to the VS System Covered Bonds will pass by registration in the register between the direct accountholders at the ISD or VP Lux in accordance with the rules and procedures of the ISD and VP Lux. The person evidenced (including any nominee) as a holder of the VS System Covered Bonds shall be treated as the holder of such VS System Covered Bonds for the purposes of payment of principal and interest on such VS System Covered Bonds. Settlement of sale and purchase transactions in respect of VS System Covered Bonds in the ISD or VP LUX will take place in accordance with market practice at the time of the relevant transaction.

Title to the VS System Covered Bonds will pass by registration in the registers between the direct accountholders at the ISD or VP LUX.

Covered Bonds that are represented by a Global Covered Bond and VS System Covered Bonds will be transferable only in accordance with the rules and procedures for the time being of Euroclear, Clearstream, VP LUX and/or ISD, (as the case may be). References to Euroclear, Clearstream, VP LUX and/or the ISD, (as the case may be) shall, whenever the context so permits, be deemed to include a reference to any additional or alternative clearing system approved by the Issuer.

Title to the Bearer Covered Bonds, Receipts and Coupons will pass by delivery. The Issuer may deem and treat the bearer of any Bearer Bond, Receipt of Coupon as the absolute owner thereof (whether or not overdue and notwithstanding any notice of ownership or writing thereon or notice of any previous loss or theft thereof) for all purposes.

## 6.3 Status of the Covered Bonds

The Covered Bonds constitute direct, unconditional, unsubordinated and secured obligations of the Issuer issued in accordance with the Act on Covered Bonds and appurtenant regulations and rank *pari passu* among themselves and with all other obligations of the Issuer that have been provided the same priority as debt instruments issued pursuant to the Act on Covered Bonds (save for certain obligations required to be preferred by law) (other than subordinated obligations, if any), from time to time outstanding. Senior Debt (if any) ranks thereafter. To the extent that claims in relation to the Covered Bonds, related derivative contracts and Senior Debt (if any) are not met out of the assets of the Cover Pool or the proceeds arising from it, the residual claims will rank *pari passu* with the claims of all other unsubordinated creditors of the Issuer (other than those preferred by law) in all other respects. The cost of bankruptcy administration, to such extent as the cost is incurred due to efforts of the bankruptcy administrator concerning the Covered Bonds and the Cover Pool, will rank ahead of claims for payments of the Covered Bonds, of related derivative contracts and of the relevant Senior Debt (if any). Other cost of bankruptcy administration shall not be paid from the assets of the Cover Pool.

## 6.4 Issuer Covenants

### *6.4.1 Negative Pledge.*

In accordance with the Act on Covered Bonds, cf. Article 12(4), the Issuer undertakes, so long as any of the Covered Bonds, Receipts or Coupons remain outstanding, that it will not, and that it will procure that none of its Relevant Subsidiaries will, create or have outstanding any mortgage, charge, pledge, lien or other security interest (each a Security Interest) over the assets in the Cover Pool, other than any lien arising by operation of law (if any).

### *6.4.2 Maintenance of the Issuer's Cover Pool.*

For so long as the Covered Bonds are outstanding, the value of the Cover Pool will not at any time be less than the total aggregate outstanding principal amount of all Covered Bonds issued under the Programme plus an Overcollateralization of 20 per cent.

For the avoidance of doubt, the Issuer shall not at any time reduce the Overcollateralization which applies to the Programme if to do so would result in any credit rating then applying to the Covered Bonds by any rating agency appointed by the Issuer in respect of the Covered Bonds being reduced, removed, suspended or placed on credit watch.

### *6.4.3 Composition of the Issuer's Cover Pool.*

For so long as any of the Covered Bonds are outstanding the Issuer shall ensure that the Cover Pool maintained or to be maintained by the Issuer shall at all times comply with the requirements of the Act on Covered Bonds.

### *6.4.4 Interest Cover*

The amounts of interest received by the Issuer in respect of the Cover Pool and under the related derivative contracts entered into by the Issuer shall be at least equal to or exceed the amounts payable by the Issuer under the Covered Bonds and the related derivative contracts entered into by the Issuer.

## 6.5 Redenomination

Where redenomination is specified in the applicable Final Terms as being applicable, the Issuer may, without the consent of the Covered Bondholders, the Receiptholders and the Couponholders, but after at least 30 days' prior notice to the Covered Bondholders in accordance with Condition 6.11, elect that, with effect from the Redenomination Date specified in the notice, the Covered Bonds shall be redenominated in euro or other Specified Currency.

The election will have effect as follows:

***6.5.1*** the Covered Bonds shall be deemed to be redenominated into euro or other Specified Currency in the denomination of euro 0.01 or as applicable to other Specified Currency with a principal amount for each Covered Bond equal to the principal amount of that Covered Bond in the Specified Currency, converted into euro or other Specified Currency at the spot rate for such conversion on the day that the relevant redenomination occurs, provided that, if the Issuer determines, that the then market practice in respect of the redenomination into euro or other Specified Currency of internationally offered securities is different from the provisions specified above, such provisions shall be deemed to be amended so as to comply with such market practice and the Issuer shall promptly notify the Covered Bondholders, the stock exchange (if any) on which the Covered Bonds may be listed of such deemed amendments;

***6.5.2*** save to the extent that an Exchange Notice has been given in accordance with paragraph 5.4 below, the amount of interest due in respect of the Covered Bonds will be calculated by reference to the aggregate principal amount of Covered Bonds presented for payment by the relevant holder and the amount of such payment shall be rounded down to the nearest euro 0.01 or as applicable in the relevant Specified Currency;

***6.5.3*** if definitive Covered Bonds are required to be issued after the Redenomination Date, they shall be issued at the expense of the Issuer in the denominations as the Issuer shall determine and notify to the Covered Bondholders;

***6.5.4*** if issued prior to the Redenomination Date, all unmatured Coupons denominated in the Specified Currency (whether or not attached to the Covered Bonds) will become void with effect from the date on which the Issuer gives notice (the Exchange Notice) that replacement euro-denominated Covered Bonds, Receipts and Coupons are available for exchange (provided that such securities are so available) and no payments will be made in respect of them. The payment obligations contained in any Covered Bonds and Receipts so issued will also become void on that date although those Covered Bonds and Receipts will continue to constitute valid exchange obligations of the Issuer. New redenominated Covered Bonds, Receipts and Coupons will be issued in exchange for Covered Bonds, Receipts and Coupons denominated in the Specified Currency in such manner as the Principal Paying Agent may specify and as shall be notified to the Covered Bondholders in the Exchange Notice. No Exchange Notice may be given less than 15 days prior to any date for payment of principal or interest on the Covered Bonds;

***6.5.5*** after the Redenomination Date, all payments in respect of the Covered Bonds, other than payments of interest in respect of periods commencing before the Redenomination Date, will be made solely in the redenomination currency;

***6.5.6*** if the Covered Bonds are Fixed Rate Covered Bonds, Inflation Linked Annuity Covered Bonds or Inflation Linked Equal Principal Payment Covered Bonds, and interest for any period ending on or after the Redenomination Date is required to be calculated for a period ending other than on an Interest Payment Date, it will be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest Sub-Unit of the relevant Specified Currency, half of any such Sub-Unit being rounded upwards or otherwise in accordance with applicable market convention; and

***6.5.7*** if the Covered Bonds are Floating Rate Covered Bonds, the applicable Final Terms will specify any relevant changes to the provisions relating to interest.

## 6.6 Interest

### *6.6.1 Interest on Inflation Linked Annuity Covered Bonds*

Each Inflation Linked Annuity Covered Bond bears interest from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest shall be calculated as defined under Interest Payment(s) in the applicable Final Terms and rounding the resultant figure to the nearest ISK. Interest will be payable in arrears on the Interest Payment Date(s) in each year up to (and including) the Maturity Date.

If interest is required to be calculated for a period other than an Interest Period, such interest shall be calculated by using the same methodology as described for Interest Payment(s) in the applicable Final Terms.

### 6.6.2 *Interest on Inflation Linked Equal Principal Payment Covered Bonds including Covered Bonds with one payment of Principal on Maturity Date*

Each Inflation Linked Equal Principal Payment Covered Bond, including Covered Bonds with one payment of principal on Maturity Date, bears interest from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest. Interest shall be calculated as defined under Interest Payment(s) in the applicable Final Terms and rounding the resultant figure to the nearest ISK. Interest will be payable in arrears on the Interest Payment Date(s) in each year up to (and including) the Maturity Date.

If interest is required to be calculated for a period other than an Interest Period, such interest shall be calculated by using the same methodology as described for Interest Payment(s) in the applicable Final Terms.

### 6.6.3 *Interest on Fixed Rate Covered Bonds*

Each Fixed Rate Covered Bond bears interest from (and including) the Interest Commencement Date at the rate(s) per annum equal to the Rate(s) of Interest.

Interest shall be calculated as defined under Interest Payment(s) in the applicable Final Terms and rounding the resultant figure to the nearest ISK. Interest will be payable in arrear on the Interest Payment Date(s) in each year up to (and including) the Maturity Date.

If interest is required to be calculated for a period other than an Interest Period, such interest shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest Sub-Unit of the relevant Specified Currency, half of any such Sub-Unit being rounded upwards or otherwise in accordance with applicable market convention.

### 6.6.4 *Interest on Floating Rate Covered Bonds*

a) Interest Payment Dates

Each Floating Rate Covered Bond bears interest from (and including) the Interest Commencement Date and such interest will be payable in arrears on either:

the Specified Interest Payment Date(s) in each year specified in the applicable Final Terms; or

if no Specified Interest Payment Date(s) is/are specified in the applicable Final Terms, each date (each such date, together with each Specified Interest Payment Date, an Interest Payment Date) which falls the number of months, or other period specified as the Specified Period in the applicable Final Terms, after the preceding Interest Payment Date or, in the case of the first Interest Payment Date, after the Interest Commencement Date.

Such interest will be payable in respect of each Interest Period (which expression shall, in these Terms and Conditions, mean the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

b) Rate of Interest

The Rate of Interest payable from time to time in respect of Floating Rate Covered Bonds will be determined in the manner specified in the applicable Final Terms.

*ISDA Determination for Floating Rate Covered Bonds*

Where ISDA Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will be the relevant ISDA Rate plus or minus (as indicated in the applicable Final Terms) the Margin (if any). For the purposes of this subparagraph (i), ISDA Rate for an Interest Period means a rate equal to the Floating Rate that would be determined by the Principal Paying Agent or other person specified in the applicable Final Terms under any interest rate swap transaction if the Principal Paying Agent or that other person were acting as Calculation Agent for that swap transaction under the terms of an agreement incorporating the 2000 ISDA Definitions, as published by the International Swaps and Derivatives Association, Inc. and as amended and updated as at the Issue Date of the first Tranche of the Covered Bonds (the ISDA Definitions), and under which:

(iii) the Floating Rate Option is as specified in the applicable Final Terms;

(iv) the Designated Maturity is the period specified in the applicable Final Terms; and

(v) unless otherwise stated in the applicable Final Terms, the relevant Reset Date is the first day of that Interest Period.

For the purposes of this subparagraph (i), Floating Rate, Calculation Agent, Floating Rate Option, Designated Maturity and Reset Date have the meanings given to those terms in the ISDA Definitions.

*Screen Rate Determination for Floating Rate Covered Bonds*

Where Screen Rate Determination is specified in the applicable Final Terms as the manner in which the Rate of Interest is to be determined, the Rate of Interest for each Interest Period will, subject as provided below, be either:

(i) the offered quotation (if there is only one quotation on the Relevant Screen Page); or

(ii) the arithmetic mean (rounded if necessary to the fifth decimal place, with 0.000005 being rounded upwards) of the offered quotations, (expressed as a percentage rate per annum) for the Reference Rate which appears or appear, as the case may be, on the Relevant Screen Page as at 11.00 a.m. (Iceland time, in the case of REIBOR, London time, in the case of LIBOR, or Brussels time, in the case of EURIBOR) on the Interest Determination Date in question plus or minus (as indicated in the applicable Final Terms) the Margin (if any), all as determined by the Issuer. If five or more of such offered quotations are available on the Relevant Screen Page, the highest (or, if there is more than one such highest quotation, one only of such quotations) and the lowest (or, if there is more than one such lowest quotation, one only of such quotations) shall be disregarded by the Issuer for the purpose of determining the arithmetic mean (rounded as provided above) of such offered quotations.

If the Reference Rate from time to time in respect of Floating Rate Covered Bonds is specified in the applicable Final Terms as being other than REIBOR, LIBOR or EURIBOR, the Rate of Interest in respect of such Covered Bonds will be determined as provided in the applicable Final Terms.

c) Minimum Rate of Interest and/or Maximum Rate of Interest

If the applicable Final Terms for a Floating Rate Covered Bond specifies a Minimum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (b) above is less than such Minimum Rate of Interest, the Rate of Interest for such Interest Period shall be such Minimum Rate of Interest.

If the applicable Final Terms for a Floating Rate Covered Bond specifies a Maximum Rate of Interest for any Interest Period, then, in the event that the Rate of Interest in respect of such Interest Period determined in accordance with the provisions of paragraph (b) above is greater than such Maximum Rate of Interest, the Rate of Interest for such Interest Period shall be such Maximum Rate of Interest.

d) Determination of Rate of Interest and calculation of Interest Amounts

The Calculation Agent will at, or as soon as practicable after, each time at which the Rate of Interest is to be determined, determine the Rate of Interest for the relevant Interest Period.

The Calculation Agent will calculate the amount of interest (each an Interest Amount) payable on the Floating Rate Covered Bonds in respect of each Specified Denomination for the relevant Interest Period. Each Interest Amount shall be calculated by applying the Rate of Interest to each Specified Denomination, multiplying such sum by the applicable Day Count Fraction, and rounding the resultant figure to the nearest Sub-Unit of the relevant Specified Currency, half of any such Sub-Unit being rounded upwards or otherwise in accordance with applicable market convention.

e) Maximum Interest Amounts

If the applicable Final Terms specifies a Maximum Interest Amount for any Interest Period, in the event that the Interest Amount in respect of such Interest Period determined in accordance with the provisions of paragraph (d) above is greater than such Maximum Interest Amount, the Interest Amount for such Interest Period shall be such Maximum Interest Amount.

f) Certificates to be final

All certificates, communications, opinions, determinations, calculations, quotations and decisions given, expressed, made or obtained for the purposes of the provisions of this Condition (6.6.4), shall (in the absence of wilful default, bad faith or manifest error as aforesaid) be binding on the Issuer and all Covered Bondholders, Receiptholders and Couponholders.

### *6.6.5 Accrual of interest*

Each Covered Bond (or in the case of the redemption of part only of a Covered Bond, that part only of such Covered Bond) will cease to bear interest (if any) from the date of its redemption unless, upon due presentation thereof, payment of principal is improperly withheld or refused. In such event, interest will continue to accrue in accordance with these Terms and Conditions. In the event of non-payment of a Zero Coupon Covered Bond, interest will accrue as provided in Condition 6.8.11.

The Covered Bonds shall bear interest from (and including) the Maturity Date to (but excluding) the earlier of the relevant Interest Payment Date after the Maturity Date on which the Covered Bonds are redeemed or the Extended Maturity Date, subject to Condition 6.8.12. In that event, interest shall be payable on those Covered Bonds at the rate determined in accordance with Condition 6.6.6 (b) on the Principal Amount Outstanding of the Covered Bonds on each Interest Payment Date after the Maturity Date in respect of the Interest Period ending immediately prior to the relevant Interest Payment Date, subject as otherwise provided in the applicable Final Terms. The final Interest Payment Date shall fall no later than the Extended Maturity Date;
The rate of interest payable from time to time under Condition 6.6.6(a) will be as specified in the applicable Final Terms and, where applicable, determined by the Calculation Agent so specified, three Business Days after the Maturity Date in respect of the first such Interest Period and thereafter as specified in the applicable Final Terms; and
In the case of Covered Bonds which are Zero Coupon Covered Bonds, for the purposes of this Condition (6.6.5) the Principal Amount Outstanding shall be the total amount otherwise payable by the Issuer on the Maturity Date less any payments made by the Issuer in respect of such amount in accordance with these Conditions.

### *6.6.6 Interest Payments up to the Extended Maturity Date*

If an Extended Maturity Date is specified in the applicable Final Terms as applying to a Series of Covered Bonds and the maturity of those Covered Bonds is extended beyond the Maturity Date in accordance with Condition 6.8.12:

a) the Covered Bonds shall bear interest from (and including) the Maturity Date to (but excluding) the earlier of the relevant Interest Payment Date after the Maturity Date on which the Covered Bonds are redeemed or the Extended Maturity Date. In that event, interest shall be payable on those Covered Bonds at the rate determined in accordance with Condition 6.6.6(b) on the Principal Amount Outstanding of the Covered Bonds on each Interest Payment Date after the Maturity Date in respect of the Interest Period ending immediately prior to the relevant Interest Payment Date, subject as otherwise provided in the applicable Final Terms. The final Interest Payment Date shall fall no later than the Extended Maturity Date;

b) the rate of interest payable from time to time under Condition 6.6.6(a) will be as specified in the applicable Final Terms and, where applicable, determined by the Issuer so specified, three Business Days after the Maturity Date in respect of the first such Interest Period and thereafter as specified in the applicable Final Terms; and

c) in the case of Covered Bonds which are Zero Coupon Covered Bonds, for the purposes of this Condition (6.6.6) the Principal Amount Outstanding shall be the total amount otherwise payable by the Issuer on the Maturity Date less any payments made by the Issuer in respect of such amount in accordance with these Conditions.

### *6.6.7 Business Day, Business Day Convention, Day Count Fraction and other adjustments*

a) In these Terms and Conditions, Business Day means:

(i) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in Reykjavík and any Additional Business Centre specified in the applicable Final Terms; and

(ii) either (A) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency as specified in applicable Final Terms (if other than Reykjavík and any Additional Business Centre and which if the Specified Currency is Australian dollars or New Zealand dollars shall be Sydney and Auckland, respectively) or (B) in relation to any sum payable in euro, a day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET) System (the TARGET System) is open.

b) If a Business Day Convention is specified in the applicable Final Terms and (x) if there is no numerically corresponding day in the calendar month in which an Interest Payment Date should occur or (y) if any Interest Payment Date would otherwise fall on a day which is not a Business Day, then, if the Business Day Convention specified is:

(i) in any case where Specified Periods are specified in accordance with Condition 6.6.4 (a), the Floating Rate Convention, such Interest Payment Date (1) in the case of (x) above, shall be the last day that is a Business Day in the relevant month and the provisions of (ii) below shall apply mutatis mutandis, or (2) in the case of (y) above, shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event (I) such Interest Payment Date shall be brought forward to the immediately preceding Business Day, and (II) each subsequent Interest Payment Date shall be the last Business Day in the month which falls the Specified Period after the preceding applicable Interest Payment Date occurred; or

(ii) the Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day; or

(iii) the Modified Following Business Day Convention, such Interest Payment Date shall be postponed to the next day which is a Business Day unless it would thereby fall into the next calendar month, in which event such Interest Payment Date shall be brought forward to the immediately preceding Business Day; or

(iv) the Preceding Business Day Convention, such Interest Payment Date shall be brought forward to the immediately preceding Business Day.

c) Day Count Fraction means, in respect of the calculation of an amount of interest for any Interest Period:

if Actual/Actual (ISMA) is specified in the applicable Final Terms:

(i) in the case of Covered Bonds where the number of days in the relevant period from (and including) the most recent Interest Payment Date (or, if none, the Interest Commencement Date) to (but excluding) the relevant payment date (the "Accrual Period") is equal to or shorter than the Determination Period (as defined in Condition 6.6.7. (d)) during which the Accrual Period ends, the number of days in such Accrual Period divided by the product of (I) the number of days in such Determination Period and (II) the number of Determination Dates (as specified in the applicable Final Terms) that would occur in one calendar year assuming that interest was to be payable in respect of the whole of that year; or

(ii) in the case of Covered Bonds where the Accrual Period is longer than the Determination Period during which the Accrual Period ends, the sum of (I) the number of days in such Accrual Period falling in the Determination Period in which the Accrual Period begins divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year; and (II) the number of days in such Accrual Period falling in the next Determination Period divided by the product of (x) the number of days in such Determination Period and (y) the number of Determination Dates that would occur in one calendar year;

if Actual/365 is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 (or, if any portion of that Interest Period falls in a leap year, the sum of (i) the actual number of days in that portion of the Interest Period falling in a leap year divided by 366, and (ii) the actual number of days in that portion of the Interest Period falling in a non-leap year divided by 365);

if Actual/365 (Fixed) is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365;

if Actual/365 (Sterling) is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 365 or, in the case of an Interest Payment Date falling in a leap year, 366;

if Actual/360 is specified in the applicable Final Terms, the actual number of days in the Interest Period divided by 360;

if 30/360, 360/360 or Bond Basis is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months (unless, in the case of Floating Rate Covered Bonds only, (i) the last day of the Interest Period is the 31st day of a month but the first day of the Interest Period is a day other than the 30th or 31st day of a month, in which case the month that includes that last day shall not be considered to be shortened to a 30-day month, or (ii) the last day of the Interest Period is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month));

if 30E/360 or Eurobond Basis is specified in the applicable Final Terms, the number of days in the Interest Period divided by 360 (the number of days to be calculated on the basis of a year of 360 days with 12 30-day months, without regard to the date of the first day or last day of the Interest Period unless, in the case of the final Interest Period, the Maturity Date is the last day of the month of February, in which case the month of February shall not be considered to be lengthened to a 30-day month); or such other Day Count Fraction as may be specified in the applicable Final Terms.

d) Determination Period means each period from (and including) a Determination Date to (but excluding) the next Determination Date (including, where either the Interest Commencement Date or the final Interest Payment Date is not a Determination Date, the period commencing on the first Determination Date prior to, and ending on the first Determination Date falling after, such date).

e) Interest Period means the period from (and including) an Interest Payment Date (or the Interest Commencement Date) to (but excluding) the next (or first) Interest Payment Date.

f) Principal Amount Outstanding means, in respect of a Covered Bond except an Inflation Linked Annuity Covered Bond and an Inflation Linked Equal Payment Covered Bond, on any day the principal amount of that Covered Bond on the Issue Date less principal amounts (if any) received by the holder of such Covered Bond in respect thereof on or prior to that day. In respect of an Inflation Linked Annuity Covered Bond and an Inflation Linked Equal Payment Covered Bond, the meaning given in the applicable Final Terms.

g) Sub-Unit means, with respect to any currency other than euro, the lowest amount of such currency that is available as legal tender in the country of such currency and, with respect to euro, euro 0.01.

## 6.7 PAYMENTS

### *6.7.1 Payments in respect of Inflation Linked Covered Bonds*

a) Payments in respect of Inflation Linked Annuity Covered Bonds

In case of an Inflation Linked Annuity Covered Bond, the Issuer shall, on each relevant Interest Payment Date, make a combined payment of principal, and interest due (together, the Annuity Amount) as calculated by the Calculation Agent in accordance with the formula specified in the applicable Final Terms.

b) Payments *in respect of Inflation Linked Equal Principal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date*

In case of an Inflation Linked Equal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date, the Issuer shall, on each relevant Interest Payment Date, make a combined payment of principal, and interest due (together, the Equal Payment Amount) as calculated by the Calculation Agent in accordance with the formula specified in the applicable Final Terms.

### *6.7.2 Method of payment*

Subject as provided below payments in a Specified Currency will be made:

a) by credit or transfer to an account in the relevant Specified Currency maintained by the payee with a bank in the principal financial centre of the country of such Specified Currency, or
b) by credit or transfer to an account in any other Specified Currency maintained by the payee with a bank in the principal financial centre of the country of such Specified Currency which shall be converted into such Specified Currency at the date of payment using the spot rate of exchange for the purchase of such currency against payment of ISK being quoted by the Fiscal Agent.

Payments will be subject in all cases to any fiscal or other laws and regulations applicable thereto in the place of payment but without prejudice to the provisions of Condition 6.7.

### *6.7.3 Presentation of definitive Covered Bonds, Receipts and Coupons*

Payments of principal in respect of definitive Bearer Covered Bonds will (subject as provided below) be made in the manner provided in paragraph 7.2 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of definitive Covered Bonds, and payments of interest in respect of definitive Covered Bonds will (subject as provided below) be made as aforesaid only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of Coupons, in each case at the specified office of any Paying Agent outside the United States (which expression, as used herein, means the United States of America (including the States and the District of Columbia and its possessions)).

Payments of instalments of principal (if any) in respect of definitive Bearer Covered Bonds, other than the final instalment, will (subject as provided below) be made in the manner provided in paragraph 7.2 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Receipt in accordance with the preceding paragraph. Payment of the final instalment will be made in the manner provided in paragraph 7.2 above only against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the relevant Covered Bond in accordance with the preceding paragraph. Each Receipt must be presented for payment of the relevant instalment together with the definitive Bearer Covered Bond presented for payment of the relevant instalment together with the definitive Bearer Covered Bond to which they appertain do not constitute valid obligations of the Issuer. Upon the date on which any definitive Bearer Covered Bond becomes due and repayable, unmatured Receipts (if any) relating thereto (whether or not attached) shall become void and no payment shall be made in respect thereof.

Fixed Rate Covered Bonds in definitive bearer form should be presented for payment together with all unmatured Coupons appertaining thereto (which expression shall for this purpose include Coupons falling to be issued on exchange of matured Talons), failing which the amount of any missing unmatured Coupon (or, in the case of payment not being made in full, the same proportion of the amount of such missing unmatured Coupon as the sum so paid bears to the sum due) will be deducted from the sum due for payment. Each amount of principal so deducted will be paid in the manner mentioned above against surrender of the relative missing Coupon at any time before the expiry of 10 years after the Relevant Date (as defined in Condition 6.10) in respect of such principal or, if later, five years from the date on which such Coupon would otherwise have become due, but in no event thereafter.

Upon any Fixed Rate Covered Bond in definitive bearer form becoming due and repayable prior to its Maturity Date, all unmatured Talons (if any) appertaining thereto will become void and no further Coupons will be issued in respect thereof.

Upon the date on which any Floating Rate Covered Bond in definitive form becomes due and repayable, unmatured Coupons and Talons (if any) relating thereto (whether or not attached) shall become void and no payment or, as the case may be, exchange for further Coupons shall be made in respect thereof.

If the due date for redemption of any definitive Bearer Covered Bond is not an Interest Payment Date, interest (if any) accrued in respect of such Bearer Covered Bond from (and including) the preceding Interest Payment Date or, as the case may be, the Interest Commencement Date shall be payable only against surrender of the relevant definitive Bearer Covered Bonds.

### *6.7.4 Payments in respect of Bearer Global Covered Bond*

Payments of principal and interest (if any) in respect of Covered Bonds represented by any Bearer Global Covered Bond will (subject as provided below) be made in the manner specified above in relation to definitive Bearer Covered Bonds and otherwise in the manner specified in the relevant Bearer Global Covered Bond, where applicable, against presentation or surrender, as the case may be, of such Bearer Global Covered Bond at the specified office of any Paying Agent outside the United States. A record of each payment, distinguishing between any payment of principal and any payment of interest, will be made on such Bearer Global Covered Bond either by the Paying Agent to which it was presented or in the records of Euroclear and Clearstream, Luxembourg, as applicable.

### *6.7.5 Payments in respect of Registered Covered Bonds*

Payments of principal (other than instalments of principal prior to the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made against presentation and surrender (or, in the case of part payment of any sum due, endorsement) of the Registered Covered Bond at the specified office of the Registrar or any of the Paying Agents. Such payments will be made by transfer to the Designated Account of the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the register of holders of the Registered Covered Bonds maintained by the Registrar (i) where in global form, at the close of the business day (being for this purpose a day on which Euroclear and Clearstream, Luxembourg are open for business) before the relevant due date, and (ii) where in definitive form at the close of business at the close of business on the third business day (being for this purpose a day on which banks are open for business in the city where the specified office of the Registrar is located) before the relevant due date. Notwithstanding the previous sentence, if (a) holder does not have a Designated Account or (b) the principal amount of the Covered Bonds held by a holder is less than U.S. $250,000 (or its approximate equivalent in any other Specified Currency), payment will instead be made by a cheque in the Specified Currency drawn on a Designated Bank. For these purposes, Designated Account means the account (which, in the case of a payment in Japanese yen to a non-resident of Japan, shall be a non-resident account) maintained by a holder with a Designated Bank and identified as such in the Registered Covered Bond Register and Designated Bank means (in the case of payment in a Specified Currency other than euro) a bank in the principal financial centre of the country of such Specified Currency (which, if the Specified Currency is Australian dollars or New Zealand dollars, shall be Sydney and Auckland, respectively) and (in the case of a payment in euro) any bank which processes payments in euro.

Payments of interest and payments of instalments of principal (other than the final instalment) in respect of each Registered Covered Bond (whether or not in global form) will be made by a cheque n the Specified Currency drawn on a Designated Bank and mailed by uninsured mail on the Business Day in the city where the specified office of the registrar is located immediately preceding the relevant due date to the holder (or the first named of joint holders) of the Registered Covered Bond appearing in the Registered Covered Bond Register (i) where in global form, at the close of the business day (being for this purpose a day on which Euroclear and Clearstream, Luxembourg are open for business)before the relevant due date, and (ii) where in definitive form, at the close of business on the fifteenth day (whether or not such fifteenth day is a business day) before the relevant due date (the Record Date) at his address shown in the Registered Covered Bond Register on the Record Date and at his risk. Upon application of the holder to the specified office of the Registrar not less than three Business Days in the city where the specified office of the Registrar is located before the due date for any payment of interest in respect of a Registered Covered Bond, the payment may be made by transfer on the due date in the manner provided in the preceding paragraph. Any such application for transfer shall be deemed to relate to all future payments of interest (other than interest due on redemption) and instalments of principal (other than the final instalment) in respect of the Registered Covered Bonds which become payable to the holder who has made the initial application until such time as the Registrar is notified in writing to the contrary by such holder. Payment of the interest due in respect of each Registered Covered Bond on redemption and the final instalment of principal will be made in the same manner as payment of the principal amount of such Registered Covered Bond.

Holders of Registered Covered Bonds will not be entitled to any interest or other payment for any delay in receiving any amount due in respect of any Registered Covered Bond as a result of a cheque posted in accordance with this Condition arriving after the due date for payment or being lost in the post. No commissions or expenses shall be charged to such holders by the Registrar in respect of any payments of principal or interest in respect of the Registered Covered Bonds.

None of the Issuer or the Paying Agents will have any responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interest in the Registered Global Covered Bonds or for maintaining, supervising or reviewing any records relating to such beneficial ownership interests.

### *6.7.6 General provisions applicable to payments*

The holder of a Global Covered Bond shall be the only person entitled to receive payments in respect of Covered Bonds represented by such Global Covered Bond and the Issuer will be discharged by payment to, or to the order of, the holder of such Global Covered Bond in respect of each amount so paid. Each of the persons shown in the records of Euroclear or Clearstream, Luxembourg as the beneficial holder of a particular nominal amount of Covered Bonds represented by such Global Covered Bond must look solely to Euroclear or Clearstream, Luxembourg, as the case may be, for his share of each payment so made by the Issuer to, or to the order of, the holder of such Global Covered Bond.

### *6.7.7 Payments in respect of VS System Covered Bonds*

VS System Covered Bonds: Payments of principal and interest in respect of VS System Covered Bonds will be made to the Covered Bondholders shown in the relevant records of the ISD, VP LUX or Clearstream/Euroclear (as the case may be) in accordance with and subject to the rules and regulations from time to time governing the ISD, VP LUX or Euroclear/Clearstream (as the case may be).

### *6.7.8 Payment Day*

If the date for payment of any amount in respect of any Covered Bond, Receipt or Coupon is not a Payment Day, the holder thereof shall not be entitled to payment of the relevant amount due until the next following Payment Day and shall not be entitled to any interest or other sum in respect of any such delay. For these purposes, Payment Day means any day which (subject to Condition 6.10) is:

a) a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in:

   the relevant place of presentation;

   Reykjavík; and

   any Additional Financial Centre specified in the applicable Final Terms.

b) either (i) in relation to any sum payable in a Specified Currency other than euro, a day on which commercial banks and foreign exchange markets settle payments and are open for general business (including dealing in foreign exchange and foreign currency deposits) in the principal financial centre of the country of the relevant Specified Currency (if other than the place of presentation, Reykjavík and any Additional Financial Centre) or (ii) in relation to any sum payable in euro, a day on which the TARGET System is open.

c) Interpretation of principal

   Any reference in these Terms and Conditions to principal in respect of the Covered Bonds shall be deemed to include, as applicable:

   the Final Redemption Amount of the Covered Bonds;

   the Early Redemption Amount of the Covered Bonds;

   the Optional Redemption Amount(s) (if any) of the Covered Bonds;

in relation to Covered Bonds (other than Inflation Linked Annuity Covered Bonds or Inflation Linked Equal Principal Payment Covered Bonds) redeemable in instalments, the Instalment Amounts;

in relation to Zero Coupon Covered Bonds, the Amortised Face Amount (as defined in Condition 6.8.7); and

any premium and any other amounts (other than interest) which may be payable under or in respect of the Covered Bonds.

## 6.8 REDEMPTION AND PURCHASE

### *6.8.1 Redemption of Inflation Linked Annuity Covered Bonds and Inflation Linked Equal Payment Covered Bonds, including Covered Bonds with one payment of Principal on Maturity Date*

Unless previously redeemed or purchased and cancelled, each Inflation Linked Annuity Covered Bond and each Inflation Linked Equal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date, will, subject to Condition 6.7.1(a) or (b) (as applicable), be redeemed in one or more amounts, calculated in accordance with the formula specified in the applicable Final Terms, in the relevant Specified Currency on the relevant Interest Payment Dates.

### *6.8.2 Final Redemption*

Unless previously redeemed or purchased and cancelled, each Covered Bond will be redeemed by the Issuer at its Final Redemption Amount specified in, or determined in the manner specified in, the applicable Final Terms in the relevant Specified Currency on the Maturity Date.

### *6.8.3 Redemption at the option of the Issuer (Issuer Call)*

If an Issuer Call is specified in the applicable Final Terms, the Issuer may, having given not less than 15 nor more than 30 days' notice to the Covered Bondholders in accordance with Condition 6.11 (which notices shall be irrevocable and shall specify the date fixed for redemption), redeem all or some only of the Covered Bonds then outstanding on any Optional Redemption Date and at the Optional Redemption Amount(s) specified in, or determined in the manner specified in, the applicable Final Terms together, if appropriate, with interest accrued to (but excluding) the relevant Optional Redemption Date. Any such redemption must be of a nominal amount not less than the Minimum Redemption Amount and not more than the Maximum Redemption Amount, in each case as may be specified in the applicable Final Terms. In the case of a partial redemption of Covered Bonds, the Covered Bonds to be redeemed (Redeemed Covered Bonds) will be selected individually without involving any part only of a Bearer Covered Bond, in the case of Redeemed Covered Bonds represented by definitive Covered Bonds, and in accordance with the rules of Euroclear and/or Clearstream, (to be reflected in the records of Euroclear and Clearstream as either a pool factor or a reduction in nominal amount, at their discretion) and in accordance with the rules of the ISD or any other relevant clearing system (as the case may be) in the case of VS System Covered Bonds in each case not more than 30 days prior to the date fixed for redemption (such date of selection being hereinafter called the Selection Date). In the Case of Redeemed Covered Bonds represented by definite Covered Bonds, a list of the serial numbers of such Redeemed Covered Bonds will be published in accordance with Condition 6.11 not less than 15 days prior to the date fixed for redemption. The aggregate nominal amount of Redeemed Covered Bonds represented by definitive Covered Bonds shall bear the same portion to the aggregate nominal amount of all Redeemed Covered Bonds as the aggregate nominal amount of definite Covered Bond outstanding bears to the aggregate nominal amount of the Covered Bonds outstanding, in each case on the Selection Date. No exchange of the relevant Covered Bond will be permitted during the period from (and including) the Selection Date to (and including) the date fixed for redemption pursuant to this Condition (6.8.3) and notice to that effect shall be given by the Issuer to the Covered Bondholders in accordance with Condition 6.11 at least five days prior to the Selection Date.

### *6.8.4 Redemption at the option of the Covered Bondholders (Investor Put)*

If Investor Put is specified in the applicable Final Terms, upon the holder of any Covered Bond giving the Issuer in accordance with Condition 6.11 not less than 15 nor more than 30 days' notice the Issuer will, upon the expiry of such notice, redeem, subject to, and in accordance with, the terms specified in the applicable Final Terms, such Covered Bond on the Optional Redemption Date and at the Optional Redemption Amount together, if appropriate, with interest accrued to (but excluding) the Optional Redemption Date. Registered Covered Bonds may be redeemed under this Condition in any multiple of their lowest Specified Denomination. It may be that before an Investor Put can be exercised, certain conditions and/or circumstances will need to be satisfied. Where relevant, the provisions will be set out in the applicable Final Terms.

To exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, if this Covered Bond is in definitive form and held outside Euroclear and Clearstream, Luxembourg, deliver, at the specified office of any Paying Agent (in the case of Bearer Covered Bonds) or the Registrar (in the case of Registered Covered Bonds) at any time during normal business hours of such Paying Agent or, as the case may be, the Registrar falling within the notice period, a duly completed and signed notice of exercise in the form (for the time being current) obtainable from any specified office of any Paying Agent or, as the case may be, the Registrar (a Put Notice) and in which the holder must specify a bank account (or, if payment is required to be made by cheque, an address) to which payment is to be made under this Condition and, in the case of Registered Covered Bonds, the nominal amount thereof to be redeemed and, if less than the full nominal amount of the Registered Covered Bonds so surrendered is to be redeemed, an address to which a new Registered Covered Bond in respect of the balance of such Registered Covered Bonds is to be sent subject to and in accordance with the provisions of Condition 6.2. If this Covered Bond is in definitive bearer form, the Put Notice must be accompanied by this Covered Bond or evidence satisfactory to the Paying Agent concerned that this Covered Bond will, following delivery of the Put Notice, be held to its order or under its control.

If the Covered Bond is represented by a Global Covered Bond or is in definitive form and held

through Euroclear or Clearstream, Luxembourg, to exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, within the notice period, give notice to the Fiscal Agent of such exercise in accordance with the standard procedures of Euroclear and

Clearstream, Luxembourg (which may include notice being given on his instruction by Euroclear or Clearstream, Luxembourg or any Common Depositary for them to the Fiscal Agent by electronic means) in a form acceptable to Euroclear and Clearstream, Luxembourg from time to time and, if this Covered Bond is represented by a Global Covered Bond, at the same time present or procure the presentation of the relevant Global Covered Bond to the Agent for notation accordingly.

If the Covered Bond is an ISD System Covered Bond, to exercise the right to require redemption of this Covered Bond the holder of this Covered Bond must, within the notice period, give notice to the Principal Paying Agent of such exercise in accordance with the standard procedures of the ISD from time to time. Any Put Notice or other notice given in accordance with the standard procedures of Euroclear and Clearstream, Luxembourg or, in the case of ISD System Covered Bonds, the ISD given by a holder of any Covered Bond pursuant to this paragraph shall be irrevocable.

### *6.8.5 Redemption due to illegality or invalidity*

If the Covered Bonds become illegal and/or invalid, the Covered Bonds of all Series may be redeemed at the option of the Issuer in whole, but not in part, at any time, on giving not less than 30 or more than 60 days' notice to all Covered Bondholders (which notice shall be irrevocable).

Covered Bonds redeemed pursuant to this Condition (6.8.5) will be redeemed at their Early Redemption Amount referred to in Condition 6.8.7 together (if appropriate) with interest accrued (and, if this is an Inflation Linked Annuity Covered Bond or an Inflation Linked Equal Principal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date, adjusted for indexation in accordance with the provisions set out in the applicable Final Terms) to (but excluding) the date of redemption.

### *6.8.6 Certification*

The publication of any notice of redemption pursuant to Condition 6.8.7 shall include a certificate signed by authorised personnel of the Issuer stating that the Issuer is entitled or required to effect such redemption and setting forth a statement of facts showing that the conditions precedent to the right of the Issuer so to redeem have occurred and the certificate shall be sufficient evidence of the satisfaction of the conditions precedent set out above, in which event it shall be conclusive and binding on all Covered Bondholders, Receiptholders and Couponholders.

### *6.8.7 Early Redemption Amounts*

For the purpose of Condition 6.8.5, each Covered Bond will be redeemed at its Early Redemption Amount calculated as follows:

a) in the case of a Covered Bond (other than a Zero Coupon Covered Bond but including an Instalment Covered Bond), at the amount specified in, or determined in the manner specified in, the applicable Final Terms or, if no such amount or manner is so specified in the applicable Final Terms, at its Principal Amount Outstanding (and, in the case of an Inflation Linked Annuity Covered Bond or an Inflation Linked Equal Principal Payment Covered Bond, including Covered Bonds with one payment of Principal on Maturity Date, adjusted for indexation in accordance with the provisions set out in the applicable Final Terms); or

b) in the case of a Zero Coupon Covered Bond, at an amount (the Amortised Face Amount) calculated in accordance with the following formula:

   Early Redemption Amount = $RP \times (1 + AY)^{y}$

   where:

   **RP** means the Reference Price;

   **AY** means the Accrual Yield expressed as a decimal; and

   $y$ is a fraction the numerator of which is equal to the number of days (calculated on the basis of a 360-day year consisting of 12 months of 30 days each) from (and including) the Issue Date of the first Tranche of the Covered Bonds to (but excluding) the date fixed for redemption or (as the case may be) the date upon which such Covered Bond becomes due and repayable and the denominator of which is 360, or on such other calculation basis as may be specified in the applicable Final Terms.

### *6.8.8 Instalments*

Instalment Covered Bonds will be redeemed in the Instalment Amounts and on the Instalment Dates. In the case of early redemption, the Early Redemption Amount will be determined pursuant to Condition 6.8.7.

### *6.8.9 Purchases*

The Issuer or any of its Subsidiaries may at any time purchase Covered Bonds at any price in the open market or otherwise. If purchases are made by tender, tenders must be available to all Covered Bondholders alike. Subject to the provision below, such Covered Bonds may be held, reissued, resold or, at the option of the Issuer, surrendered to the Issuer for cancellation.

### *6.8.10 Cancellation*

All Covered Bonds which are redeemed will forthwith be cancelled (together with all unmatured Receipts and Coupons attached thereto or surrendered therewith at the time of redemption). All Covered Bonds so cancelled and any Covered Bonds purchased and surrendered for cancellation pursuant to Condition 6.8.9 and cancelled (together with all unmatured Receipts and Coupons cancelled therewith) shall be forwarded to the Issuer and in the case of VS System Covered Bonds shall be deleted from the records of the ISD, VP LUX or any other relevant clearing system (as the case may be) and cannot be reissued or resold.

### *6.8.11 Late Payment on Zero Coupon Covered Bonds*

If the amount payable in respect of any Zero Coupon Covered Bond upon redemption of such Zero Coupon Covered Bond pursuant to Conditions 6.8.2, 6.8.3 or 6.8.5 above, the amount due and repayable in respect of such Zero Coupon Covered Bond shall be the amount calculated as provided in Condition 6.8.7 (b) above as though the references therein to the date fixed for the redemption or the date upon which such Zero Coupon Covered Bond becomes due and payable were replaced by references to the date which is the earlier of:

a) the date on which all amounts due in respect of such Zero Coupon Covered Bond have been paid; and
b) five days after the date on which the full amount of the moneys payable in respect of such Zero Coupon Covered Bonds has been received by the Issuer and notice to that effect has been given to the Covered Bondholders in accordance with Condition 6.11.

### *6.8.12 Extension of Maturity Date*

a) Extended Maturity Date:

An Extended Maturity Date shall be specified in the applicable Final Terms as applying to each Series of Covered Bonds unless to do so would result in the Issuer being unable to obtain if applicable the relevant credit rating from the relevant rating agencies appointed by the Issuer at the relevant time in respect of a Series of Covered Bonds.

b) Automatic Extension:

If an Extended Maturity Date is specified in the applicable Final Terms as applying to a Series of Covered Bonds and the Issuer fails to redeem the relevant Covered Bonds in full on the Maturity Date or within three Business Days thereafter, the maturity of the outstanding Covered Bonds and the date on which such Covered Bonds will be due and repayable for the purposes of these Terms and Conditions will be automatically extended up to but no later than the Extended Maturity Date, subject as otherwise provided for in the applicable Final Terms. In that event, the Issuer may redeem all or any part of the Principal Amount Outstanding of the Covered Bonds on any Interest Payment Date falling in any month after the Maturity Date up to and including the Extended Maturity Date or as otherwise provided for in the applicable Final Terms. The Issuer shall give notice to the Covered Bondholders (in accordance with Condition 6.11 (Notices)) of its intention to redeem all or any of the Principal Amount Outstanding of the Covered Bonds at least five Business Days prior to the relevant Interest Payment Date. Any failure by the Issuer to notify such persons shall not affect the validity or effectiveness of any redemption by the Issuer on the relevant Interest Payment Date, or give rise to rights to any such person.

The Issuer is not required to notify the Covered Bondholders of such automatic deferral.

c) Zero Coupon Bonds:

In the case of Covered Bonds which are Zero Coupon Covered Bonds to which an Extended Maturity Date is specified under the applicable Final Terms, for the purposes of this Condition (6.8.12) the Principal Amount Outstanding shall be the total amount otherwise payable by the Issuer on the Maturity Date less any payments made by the Issuer in respect of such amount in accordance with these Terms and Conditions.

d) Extension Irrevocable:

Any extension of the Maturity Date under this Condition (6.8.12) shall be irrevocable. Where this Condition (6.8.12) applies, any failure to redeem the Covered Bonds on the Maturity Date or any extension of the Maturity Date under this Condition (6.8.12) shall not constitute an event of default or acceleration of payment for any purpose or give any Covered Bondholder any right to receive any payment of interest, principal or otherwise on the relevant Covered Bonds other than as expressly set out in these Terms and Conditions.

e) Payments:

In the event of the extension of the maturity of Covered Bonds under this Condition (6.8.12) Interest Rates, Interest Periods and Interest Payment Dates on the Covered Bonds from (and including) the Maturity Date to (but excluding) the Extended Maturity Date shall be determined and made in accordance with the applicable Final Terms.

Interest will continue to accrue on any unpaid amount and be payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date.

Furthermore, in relation to all amounts constituting accrued interest due and payable on each Interest Payment Date falling after the Maturity Date up to (and including) the Extended Maturity Date, as provided in the applicable Final Terms, the Issuer may pay such interest pursuant to the Floating Rate set out in the applicable

Final Terms notwithstanding that the relevant Covered Bond was a Fixed Rate Covered Bond as at its relevant Issue Date.

f) Partial Redemption after Maturity Date:

If the Issuer redeems part and not all of the Principal Amount Outstanding of Covered Bonds on any Interest Payment Date falling after the Maturity Date, the redemption proceeds shall be applied rateably across the Covered Bonds and the Principal Amount Outstanding on the Covered Bonds shall be reduced by the level of that redemption. If any partial redemption after the Maturity Date is not sufficient to redeem all outstanding Interest Payments, then the remainder of any Interest Payment shall be added to the principal amount of the Covered Bonds.

g) Restriction on Further Issues:

If the maturity of any Covered Bonds is extended up to the Extended Maturity Date in accordance with this Condition (6.8.12) subject as otherwise provided for in the applicable Final Terms, for so long as any of those Covered Bonds remains outstanding, the Issuer shall not issue any further Covered Bonds, unless the proceeds of issue of such further Covered Bonds are applied by the Issuer on issue to redeem in whole or in part the relevant Covered Bonds in accordance with the terms hereof.

### *6.8.13 Redemption for Tax Reasons*

The Covered Bonds may be redeemed at the option of the Issuer in whole, but not in part, at any time or on any Interest Payment Date, on giving not less than 30 nor more than 60 days' notice to the ISD and, in accordance with Condition 6.11 (Notices), the Covered Bondholders (which notice shall be irrevocable), if:

a) on the occasion of the next payment due under the Covered Bonds, the Issuer has or will become obliged to pay additional amounts as provided or referred to in Condition 6.9 (Taxation) as a result of any change in, or amendment to, the laws or regulations in Iceland or any political subdivision or any authority thereof or any authority or agency therein having power to tax, or any change in the application or official interpretation of such laws or regulation, which change or amendment becomes effective on or after the Issue Date of the first Tranche of the Covered Bonds; and
b) such obligation cannot be avoided by the Issuer taking reasonable measures available to it.

Covered Bonds redeemed pursuant to this Condition (6.8.13) will be redeemed at their Early Redemption Amount together (if appropriate) with interest accrued to (but excluding) the date of redemption.

## 6.9 Taxation

All payments of principal and interest in respect of the Covered Bonds and Coupons by the Issuer will be made without, or deduction for or on account of, any present or future taxes, duties assessments or governmental charges of whatever nature imposed or levied by or on behalf of Iceland or any political subdivision or any authority or agency thereof or therein having power to tax unless such withholding or deduction is required by law. In such event, the Issuer will pay such additional amount as shall be necessary in order that the net amounts received by the holders of the Covered Bonds and Coupons after such withholding or deduction shall equal the respective amounts of principal and interest which would otherwise have been receivable in respect of the Covered Bonds or Coupons, as the case may be, in the absence of such withholding or deduction, except that no such additional amounts shall be payable with respect to any Covered Bond or Coupon:

e) in respect of any demand made for payment in Iceland; or
f) in respect of any demand made for payment by or on behalf of a holder who is liable for such taxes, duties, assessments or governmental charges in respect of such Covered Bond or Coupon by reason of it having some connection with Iceland other than the mere holding of such Covered Bond or Coupon; or
g) in respect of any demand made for payment more than thirty days after the Relevant Date (as defined below) except to the extent that the holder thereof would have been entitled to an additional amount on making such demand for payment on or before the expiry of such period of thirty days; or
h) in respect of any demand made for payment by or on behalf of a holder who would be able to avoid such withholding or deduction by making a demand in respect of the Covered Bond or Coupon to another Paying Agent in a Member State of the European Union.

where such withholding or deduction is required to be made based on provisions of the Act on Withholding of Public Levies at Source No. 45/1987, as amended, the Act on Withholding of Tax on Financial Income No. 94/1996, as amended, and Article 3 of the Income Tax Act No. 90/2003 ("ITA"), and any other legislation, laws or regulations, replacing or supplementing the same.

### 6.10 Prescription

The Covered Bonds, Receipts and Coupons will become void in accordance with Act on the Expiration of Debt and other Obligations No. 150/2007 unless presented for payment within 10 years (in the case of principal) and four years (in the case of interest or any other amount) after the Relevant Date (as defined below).

There shall not be included in any Coupon sheet issued on exchange of a Talon, any Coupon the claim for payment in respect of which would be void pursuant to this Condition or Condition 6.7.3 or any Talon which would be void pursuant to Condition 6.7.3.

For the purposes of these Terms and Conditions, Relevant Dat**e** means the date on which such payment first becomes due, except that, if the full amount of the moneys payable has not been duly received by the Principal Paying Agent on or prior to such due date, it means the date on which, the full amount of such moneys having been so received, notice to that effect is duly given to the Covered Bondholders in accordance with Condition 6.11.

### 6.11 Notices

All notices regarding the Covered Bonds will be valid if published in a manner which complies with the rules and regulations of the relevant act which apply to publicly listed securities, and/or any stock exchange and/or any other relevant authority on which the Covered Bonds are for the time being listed or by which they have been admitted to trading. Any such notice will be deemed to have been given on the date of the first publication. The Issuer can additionally at its own discretion obtain information from the ISD or VP Lux on the Covered Bondholders in order to send notices to each Covered Bondholder directly.

Notices to be given by any Covered Bondholder shall be in writing and given by lodging the same, together with the relevant Covered Bond or Covered Bonds.

### 6.12 Further Issues

The Issuer shall be at liberty from time to time without the consent of the Covered Bondholders, the Receiptholders or the Couponholders to create and issue further covered bonds having terms and conditions the same as the Covered Bonds or the same in all respects save for the amount and date of the first payment of interest thereon and so that the same shall be consolidated and form a single Series with the outstanding Covered Bonds.

### 6.13 Governing Law and Jurisdiction

The Covered Bonds (except for the ISD System Covered Bonds), the Receipts, the Coupons are governed by, and shall be construed in accordance with, English law except for Condition 6.3 (Status of Covered Bonds), which will be governed by, and construed in accordance with Icelandic Law.

The Issuer irrevocably agrees that any dispute arising out of the Programme, the Covered Bonds, the Coupons, the Receipts shall be subject to the exclusive jurisdiction of the Courts of England.

The ISD System Covered Bonds will be governed by, and construed in accordance with Icelandic law.

The Issuer irrevocably agrees that any dispute arising out of the ISD System Covered Bonds shall be subject to the exclusive jurisdiction of the District Court of Reykjavík (*Ice. "Héraðsdómur Reykjavíkur"*).

Legal action taken under this Condition (6.13) may be proceeded with in accordance with the Act on Civil Procedure No. 91/1991 (*Ice. "Lög um meðferð einkamála"*), Chapter 17.

# 7 SUMMARY OF ICELANDIC LEGISLATION IN CONSIDERATION OF COVERED BONDS

The Act on Covered Bonds was adopted by the Icelandic Parliament on 4 March 2008. This legislation enables Icelandic commercial banks, savings banks and credit undertakings which have been duly licensed to issue covered bonds as defined therein.

The Issuer is licensed by the FME under the Act on Covered Bonds which enables it to issue the Covered Bonds. The following constitutes a general summary of the Icelandic legislation governing the issuance of covered bonds in Iceland, at the date and pursuant to this Base Prospectus, which law may be supplemented, amended, modified or varied by legislative enactment or by way of judicial decisions and administrative pronouncements, including possibly, with retroactive effect. The summary does not purport nor shall be construed as being an exhaustive description or presentation of all aspects of the Covered Bond Legislation. The original language of the Act on Covered Bonds is Icelandic. The relevant legislation, executive orders and or regulations in the original Icelandic version should be consulted in the event of any doubt.

## 7.1 Covered Bonds

The Act on Covered Bonds defines “covered bonds” as bonds and other unilateral, unconditional, written debt obligations which enjoy a right of priority over the cover pool (as defined below) of an issuer and which are issued in compliance with the Act on Covered Bonds.

## 7.2 Cover Pool

The Act on Covered Bonds defines a “cover pool” as the collection of bonds, substitute collateral and other assets that have been registered on a register in a accordance with Chapter VI of the Act on Covered Bonds and covered bondholders and counterparties of the issuer under derivative agreements have a priority claim to seek enforcement in respect of such assets in accordance with the Act on Covered Bonds.

A cover pool will consist of certain assets, which include bonds secured by various types of mortgages, on other registered assets, bonds granted to or guaranteed by certain governmental bodies (“Government Bonds”), receivables in the form of certain derivative agreements and substitute collateral.

The real property and the registered assets which serve as security for the bonds included in the cover pool must be located in a member state of the European Economic Area, the European Free Trade Association Treaty, or the Faroe Islands (each a “Cover Pool Member State” and collectively the “Cover Pool Member States”). A cover pool will consist primarily of mortgage bonds secured against residential property; industrial, office or commercial property; agricultural property; debt instruments including those issued by the Icelandic state or another member state, municipality in Iceland or in another member state, or guaranteed by such member state within the European Economic Area and certain collateral up to a specific limit of the value of the relevant cover pool.

Substitute collateral are assets that may be included in the cover pool and are intended to ensure that the interests of covered bondholders are not prejudiced despite changes which may occur to the assets of the cover pool. The cover pool may include the following substitute collateral; (1) Demand deposits with a financial undertaking; (2) Deposits with or claims against a Cover Pool Member State or central bank in a Cover Pool Member State; (3) Claims against other legal entities which in the FME’s evaluation, do not involve greater risk than those in previous points (1) and (2) above. Substitute collateral may not comprise more than 20% of the value of the cover pool. The FME may, however, authorise an increase in the proportion of substitute collateral in the cover pool to as much as 30% of its value.

Assets in the cover pool are to be kept separate from other business operations of the issuer, as further defined in chapter 7.6 below.

## 7.3 Cover Pool Assets

Eligible cover pool assets consist primarily of mortgage bonds issued by borrowers against collateral in the form of real property or public credit (i.e. loans to creditors with high credit worthiness, such as the State of Iceland, Icelandic municipalities and foreign central banks). Collateral for mortgage bonds shall consist of:

Pledged real property designated for residential purposes;
Pledged real property designated for industrial, office or business purposes; and,

Pledged real property designated for agricultural purposes.

The collateral may form part of the cover pool only to the extent that on the date of registration the ratio of the principal balance of the mortgage bond compared to the market value ( "LTV") in relation to the collateral does not exceed:

80% of the market value for real property designated for residential purposes;
70% of the market value for real property designated for agricultural purposes; and,
60% of the market value for real property designated for industrial, office or commercial purposes.

Furthermore, the mortgage bonds issued against mortgages in residential, industrial, office, commercial or agricultural purposes may not be registered in the cover pool if payment is in arrears of 90 days or more.

The market value of real properties is assessed by an appraisal which must be based on the selling price in recent transactions with comparable properties. The issuer shall regularly monitor the development of such selling prices. If the market value of collateral in the cover pool (i.e. the underlying mortgaged real estate) substantially decreases, the amount of the value of the assets in the cover pool shall be decreased to ensure that the LTV lies within the limits described above. If the market value or selling price in recent transactions with comparable properties is not available it shall be determined by a specific valuation. The valuation shall be based on generally accepted principles for market valuation of real estate. Data on real estate price developments from the Registers Iceland (*Ice*. "*Þjóðskrá Íslands*"), for instance, may be used as a basis, together with other systematic collection of real estate price data.

If an issuer assesses the market value of real estate in accordance with the foregoing, the Independent Inspector provided for in Chapter VIII of the Act on Covered Bonds, must verify that the appraisal is based on an accepted methodology. The Independent Inspector may re-assess the market price of one or more properties if it is believed to be valued incorrectly. An appraisal of the market value of real estate must be in writing and specify what methodology is used, who has carried out the appraisal and when it was made.

## 7.4 Matching Rules

An issuer of covered bonds must ensure that the total current value of a cover pool which is to serve as collateral for a specific class of covered bonds always exceeds the aggregate total current value of that class of covered bonds. Moreover, instalments and other cash flows accruing on the assets in the cover pool and from derivative agreements shall be in such a manner that at any given time the issuer can meet all its financial obligations to covered bondholders and counterparties to derivative agreements.

In order to maintain a suitable balance between the cover pool and the corresponding class of covered bonds, the issuer (a) must ensure that the assets in the cover pool (including substitute collateral) are valued having proper regard to currency exchange rates, interest rates, maturity dates, and other relevant factors; and (b) may enter into derivative agreements for the purpose of achieving this balance.

## 7.5 FME Supervision

The issue of covered bonds requires a licence from the FME, which monitors compliance with the Act on Covered Bonds as well as being the supervisory authority for the business operations of an issuer conducted in connection with the issue of covered bonds. A license from the FME requires, *inter alia*, that the issuance comply with the Act on Covered Bonds and that a certified public accountant certify that the issuer's budget and accounts demonstrate that its financial situation is stable enough not to jeopardise the interests of other creditors. Furthermore, the FME may grant the licence subject to specified conditions.

The FME may revoke an issuer's license to issue covered bonds if (a) the issuer no longer fulfils the requirements to issue covered bonds; (b) the issuer's budget, as attested to by a certified public accountant, demonstrates that its financial situation is no longer sufficiently sound so that the issuance of covered bonds will jeopardise the interests of other creditors; or (c) the issuer violates provisions of the Act on Covered Bonds or rules adopted by virtue of it. If the FME revokes the issuer's license to issue the covered bonds it shall decide how to terminate the activities of the issuer.

The FME may authorise that previously issued bonds and other comparable debt instruments which were issued for the purposes of financing the assets in a cover pool may be converted to covered bonds under the Act on Covered Bonds.

### 7.6 The Register

The issuer of covered bonds must maintain a Register (The "Register") of the issued covered bonds, and the cover pool, together with related derivative agreements in accordance with the Act on Covered Bonds. The Register must, among other things include the following information; (1) the nominal value, interest terms, and final maturity of the covered bonds; (2) the types of assets in the cover pool; and (3) in respect of each mortgage bond in the cover pool, the name of the underlying borrower, their ID./Reg. No., the nominal value of the loan, date of issue, maturity, terms of instalments and interest. Furthermore, the Register shall show the appraisal of the collateral security in the cover pool, when the appraisal was carried out and the premises used. Bonds in a cover pool must be endorsed showing they are part of a cover pool and have been entered into the Register as provided for in Chapter VI of the Act on Covered Bonds. The endorsement shall also indicate that the debt instrument is to secure priority rights of a specific class of covered bonds.

### 7.7 Independent Inspector

The issuer shall appoint an Independent Inspector to supervise the issuance of covered bonds licensed by the FME and the FME must approve his appointment in accordance with the Act on Covered Bonds. In seeking FME's approval for the Independent Inspector's appointment, an issuer must disclose possible interrelation between the Independent Inspector and the issuer. The Independent Inspector must fulfil the eligibility criteria prescribed in the Act on Covered Bonds and is assigned the task of monitoring that the Register is maintained in accordance with the provisions of the Act on Covered Bonds and to verify that the valuation of collateral for bonds in the cover pool is based on proper methodology. The Independent Inspector shall report regularly to the FME on his observations and immediately inform the FME of any circumstances he becomes aware of, that could affect the FME's assessment of the issuer as frequently and in such format as the FME decides, or above and beyond this if exceptional circumstances so warrant.

### 7.8 Rights of Priority

In the event of bankruptcy of an issuer of covered bonds, covered bondholders and derivative agreement counterparties are entitled to rights of priority to the assets in the cover pool that are registered in the Register, as well as over the funds that originate from those assets.

### 7.9 Handling of assets in the event of winding up of an issuer

If an issuer enters into winding-up proceedings, any issued covered bonds do n ot fall due unless it was specifically agreed otherwise. Furthermore, any derivative agreements entered into by the issuer in relation thereto shall not accelerate upon the winding up of the issuer and such agreements may not include provisions on automatic termination of contracts under such circumstances. In case of the winding up of an issuer, the winding-up committee shall keep the covered bonds, substitute collateral and other assets in the cover pool segregated from other assets of the issuer's estate. The same shall apply to funds and other assets substituted for the covered bonds, substitute collateral and other assets in the cover pool, or paid in respect of such assets. Such separation shall be maintained until claims arising from the covered bonds have been paid in full.

The winding-up committee shall also keep derivative agreements, and funds returned by such assets or which must be paid from the cover pool to the counterparties to those derivative agreements, separate from other assets of the issuer's estate.

Payments received by the issuer after the date of a winding-up order in respect of funds and other assets substituted for the covered bonds, substitute collateral and other assets in the cover pool intended for payment of claims, including fulfilment of derivative agreements, shall be entered in the Register by the winding-up committee.

Article 17(1) of the Act on Covered Bonds states that the winding-up committee shall fulfil the issuer's commitments under the covered bonds and derivative agreements using mortgage bonds and other assets in the cover pool and payments received on such assets provided that these assets are listed in the Register.

The separation of the cover pool shall be maintained until claims arising from the covered bonds have been paid in full. The general rule is that to the extent that a cover pool is not sufficient to cover the covered bonds and derivative agreements, the covered bondholders may continue to file claims as non-preferential creditors of the issuer and to receive dividends from the other assets of the issuer and be ranked *pari passu* with other, general non-prioritised non-preferential creditors of the issuer.

According to the Bankruptcy Act No. 21/1991 ("Bankruptcy Act") the covered bondholders' priority rights to the cover pool rank third after; (a) third party's assets held by an issuer, provided that the third party can prove his entitlement to the asset (no such third party's assets should be a part of the cover pool); (b)(i) certain bankruptcy (winding up) costs; (ii) third party claims incurred after the date of the winding-up order due to agreements made on behalf of the bankruptcy estate by the winding-up committee or to liability for losses incurred by third parties as a result of any negligent act of the bankruptcy estate; and (iii) lawful third party claims, including claims due to derivative agreements concluded in accordance with the provisions of the Act on Covered Bonds, incurred by the estate after the date of a moratorium order or a composition proceedings order, if applicable.

If an issuer seeks composition with creditors, the composition arrangement will not affect claims which benefit from security (such as the claims of covered bondholders), to the extent the security is sufficient to settle the claim and the security interest will not cease to exist as a result of the composition agreement. However, according to Article 60(4) of the Bankruptcy Act, if the creditor values the collateral as being insufficient to meet his claim, he may (in order to increase the chances of recovery) partly waive his right to a secured claim and thereby partly obtain a contractual claim on the debtor, to the extent of such waiver.

The part of the winding-up costs that concerns the covered bonds, the cover pool, and payments with respect to the covered bonds, cover pool or derivative agreements, shall be paid from the cover pool. Payments received by the issuer after the date of the winding-up order in accordance with the terms and conditions governing the cover pool should be entered in the Register.

Notwithstanding the provisions of Chapter XX of the Bankruptcy Act, No. 21/1991, actions taken by an issuer in accordance with the Act on Covered Bonds, including the delivery of funds or substitute collateral to the cover pool, payments on the cover pool, or disposal of funds from the cover pool to fulfil obligations under a covered bond or a derivative agreement concluded in accordance with the Act on Covered Bonds and in connection with the cover pool, shall not be subject to annulment or claw-back.

In relation to specific risk factors of the Act on Covered Bonds that have been identified, please refer to the section on *Risk Factors* above.

### 7.10 The Rules

FME has issued Rules No. 528/2008 on Covered Bonds that concern among other things, the conditions for being granted licence to issue covered bonds, appraisal and revaluation of the assets in the cover pool, matching rules, derivative agreements, the Register and the eligibility and reporting of the Independent Inspector. The Rules are issued with reference to the Act on Covered Bonds and elaborate on the provisions of said Act.

The Rules list the documents to be provided to the FME by an issuer who applies for FME's licence to issue covered bonds. Such documents include, among other things, approvals, descriptions of the proposed programme, the issuer's budget, information on data systems, etc. The Rules describe the assets which are eligible to be registered to the cover pool and how the eligibility of such assets shall be evaluated.

The Rules provide further clarification with respect to matching requirements and provide a method of calculating the present value of assets/liabilities in relation thereto. The Rules prescribe that an issuer shall complete such calculations as often as deemed necessary and at least on a weekly basis.

The Rules provide for certain restrictions to the provisions and counterparties of derivative agreements. Such agreements may not include provisions on automatic termination of contracts upon the winding up of the issuer. Furthermore, counterparties to derivative agreements must have a financial strength rating from a fully accredited rating agency and such a rating may not fall below the limits listed in the table below. If another rating agency has given the respective counterparty a lower rating, it has to receive ratings from at least two accredited rating agencies giving it equal or higher rating than listed in the following table:

| Rating Agency | Minimum rating | |
|---|---|---|
| | Long Term | Short Term |
| Moody's | A3 | P2 |
| Standard & Poor's | A- | A2 |
| Fitch | A- | F2 |

The Rules provide further detail on the Register. The Register shall be kept in a secure manner and updated on a daily basis. The FME shall have access to the Register.

Furthermore, the Rules provide further detail on the obligations of the Independent Inspector to be appointed by the issuer. The Independent Inspector shall ensure that the Register is properly maintained and updated and shall therefore verify that bonds and derivative agreements are correctly registered; only eligible assets and substitute collateral are included in the cover pool; the value of the assets registered in the cover pool and the valuation thereof is in accordance with the Act on Covered Bonds and the Rules; that LTV calculations are correctly updated upon significant decrease in the market value of mortgaged assets; and that the matching rules are complied with.

The Independent Inspector shall once a year provide the FME with a written report regarding his/her surveillance. Furthermore, the Independent Inspector shall as soon as possible notify the FME should he/she become aware of any matters which could affect the FME's assessment of the issuer's position in general. An Indipendent Inspector has been appointed pursuant to an agrrement with PricewaterhouseCoopers ehf. ("PwC").

## 7.11 The Issuer's licence to issue Covered Bonds

On 29 April 2013 the FME granted the Issuer a licence to issue Covered Bonds under the Act on Covered Bonds. Pursuant to the terms of such a licence, the Issuer is able, from time to time, to issue Covered Bonds that entitle the holder to the benefit of a statutory preferred creditor status in respect of the assets contained in the Issuer's Cover Pool in the event of the insolvency of the Issuer.

The licence was granted on 29 April 2013 and is subject to the requirements specified here below:

- The Programme shall intially not exceed a limit of ISK 10,000,000,000. Any further increase of the Programme is subject to the approval of the FME.
- The Programme and the Cover Pool shall be in ISK. The Cover Pool shall only consist of bonds in accordance with item 1 of Paragraph 1 of Article 5 of the Act on Covered Bonds and replacement collateral in accordance with Paragraph 1 of Article 6 of the Act.
- The aggregated total amount of bonds and other assets in the Cover Pool shall not exceed a level of 30% above the issued Covered Bonds at any time unless increased demand has developed due to other provisions of the Act on Covered Bonds, such as due to stress tests or present value calculations. If the Cover Pool exceeds the aforementioned limit the Issuer shall notify the FME and the Independent Inspector immediately. The Issuer shall remedy the level within 14 days.
- The Independent Inspector shall on a quarterly basis file a report to the FME regarding his supervision duties. The report shall be filed every three months from the Issue Date and shall contain information stipulated in Paragraph 3 of Article 16 of the Rules. This requirement shall be revised twelve months from the Issue Date of the Covered Bonds.
- The Independent Inspector shall at any Issue Date verify that the provisions of Chapters II and III of the Act on Covered Bonds, with regards to assets of the Cover Pool and Mortgages, are fulfilled.
- The Issuer shall at least weekly execute stress tests and calculate the present value of the Cover Pool.
- The Issuer shall at least quarterly disclose information to the the Covered Bondholders about key figures regarding the Programme, e.g. outcome of any stress tests and the calculation of the present value of the Cover Pool. Furthermore, the Issuer shall allow the Independent Inspector to submit its remarks, if any, regarding this disclosure of information obligation of the Issuer.

# 8 TAXATION

## 8.1 Icelandic taxation

The comments below are of a general nature based on the Issuer's understanding of current law and practice in Iceland. They relate only to the position of persons who are the absolute beneficial owners of the Covered Bonds to be issued under this Base Prospectus. They may not apply to certain classes of person such as dealers. Prospective holders of the Covered Bonds to be issued under this Base Prospectus who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers.

## 8.2 Non- Icelandic tax resident

Natural and legal persons that are not residents in Iceland and receive interest payments from Iceland are as a general principle considered to have limited tax liability in Iceland according to Article 3(8) of the Income Tax Act No. 90/2003 ("ITA") and are as such subject to 10% capital income tax. The tax liability applies both to interest payment as such but also to capital gains on the bonds, since such gains are taxed in Iceland as interest payments. The abovementioned Article 3(8) of the ITA provides nevertheless for certain tax exemptions.

Article 3 (8) of the ITA states:

*"All entities who receive interest income in this country from bank deposits, securities- or investment funds, debentures or other claims or financial contracts, as noted in item 3, section C of Article 7, shall pay income tax on such income. This provision neither applies to interest paid by the Central Bank of Iceland in its own name nor to interest paid to foreign states, international institutions or other public entities that are exempt from taxation in their country of domicile. This provision does not apply to interest income from bonds issued by Financial Undertakings as defined in point 1. of the 1st. Paragraph of Article 4 of Act No. 161/2002, On Financial Undertakings,… Under the conditions that the bonds must be issued by a Securities Depository in a member state of the Organization for Economic Co-operation and Development (OECD), a member state of the European Economic Area or a founding member of EFTA or in the Faroe Islands and the trading must not be covered by the provisions of Article 13. b – 13. n of the Act No. 87/1992, On Foreign Exchange. This provision does not apply if a double-taxation agreement that Iceland has concluded with a foreign country states that a withholding tax on interest shall not be retained. The Minister of Finance is authorised to issue a regulation that further specifies the implementation of this provision.*

See also Regulation No 630/2013 from 3 July 2013.

Individuals are not subject to taxation on interest income up to ISK 100,000 or lower per year. Additionally, a non-Icelandic tax resident may be exempt from such taxation of interest, by virtue of a Double Taxation Treaty that the Government of Iceland has concluded with the Government of the home state of the non-Icelandic tax resident, which provides for relief from double taxation. In such circumstances, the taxable person (the recipient of the interest payments) must apply for such exemption to the Directorate of Internal Revenue by filing an application (form RSK 5.42) for exemption from such withholding. If an application is not made prior to such withholding, a tax refund for the withholding tax can be claimed through the same channels (form RSK 5.43).

There are no estate or inheritance taxes, succession duties or gift taxes taxes imposed by Iceland or any authority of or in Iceland in respect of the Covered Bonds if, at any time of the death of the holder or the transferee of the Covered Bonds, such holder or transferor is not a resident of Iceland.

Non resident individuals are subject to net wealth tax according to Temporary Provision XLVII to the Income Tax Act No. 90/2003 on net value of Icelandic assets that are more than ISK 75 million for individuals. The tax brackets and tax rates (1.5-2.0%) for net wealth tax vary depending on marital status and the value of Icelandic assets.

## 8.3 Icelandic tax residents

Beneficial owners of the Covered Bonds residing in Iceland for tax purposes are subject to income tax in Iceland on their interest income in accordance with Icelandic tax law. The rate depends on their tax status. Subject to certain exemptions, applicable to e.g. most banks and pension funds, the Issuer is required to withhold a 20 per cent. tax on the interest paid to the holders of Covered Bonds which is considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder. As with non-Icelandic tax residents, Icelandic tax residents do not pay tax on interest payments of up to ISK 100,000 per year. Indivuals are subject to net wealth tax according to Temporary Provision XLVII to the Income Tax Act No. 90/2003 on net value of

Icelandic assets that are more than 75 million Icelandic Krona for individuals. The tax brackets and tax rates (1.5-2.0%) for net wealth tax vary depending on marital status and the value of Icelandic assets.

# 9 APPENDIX

**9.1 Condensed, consolidated Interim Financial Statements for the six months ended 30 June 2013.**

**9.2 Consolidated Financial Statements for the year 2012**

**9.3 Consolidated Financial Statements for the year 2011**

**9.4 Articles of Association**

# Condensed Consolidated Interim Financial Statements

for the six months ended 30 June 2013

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# Endorsement and Statement by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Landsbankinn hf. (the "Bank" or "Landsbankinn") for the first six months of 2013 include the Bank and its subsidiaries (collectively referred to as the "Group").

## Operations

The Group's profit for the first six months of the year 2013 was ISK 15,525 million. The Group's equity at the end of this period amounted to ISK 229,830 million. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 25.9%. As of 30 June 2013, the Group's total assets amounted to ISK 1,126,094 million.

On 11 April 2013, the third-party valuation agent Deloitte UK LLP concluded its valuation of specified assets in relation to the Bank's liability originally classified as a contingent bond, with the result that the contingent bond has been issued as secured bonds in the equivalent amount of ISK 92,000 million, denominated in EUR (50%), USD (30%) and GBP (20%). LBI hf. has in return surrendered its entire holding in Landsbankinn to the Icelandic State and Landsbankinn.

Following the change in ownership, the Icelandic State holds 98% of shares in Landsbankinn while Landsbankinn received 2% of own shares in accordance with the settlement agreement of 15 December 2009 between the Bank, LBI hf. and the Icelandic State. The Bank received the shares from LBI hf. with the obligation to allocate them to employees. Shareholders' meeting of the Bank, which was held on 17 July 2013, approved the allocation of the shares to the employees, who will receive around 1% of the shares, with the remaining shares being retained by the Bank for settlement of the tax obligations and pension liabilities of its employees. In addition, employees are obliged to comply with specific requirements for the sale of the shares.

In June 2013, the Group's remaining 25% of shares in the facilities management company Reginn hf. were sold in a public offering and the acquirers received their shares as of 10 June 2013. The proceeds of the offering amounted to ISK 4,068 million and the average share price of accepted offers was ISK 12.52 per share.

## Risk management

On 10 June 2013, Landsbankinn issued its first series of Covered Bonds, LBANK CB 16, in the amount of ISK 1,160 million. The Covered Bonds programme provides additional financing for the Bank's housing loan portfolio and reduces the Bank's interest rate risk.

On 30 May 2013, the Supreme Court ruled in case No. 50/2013, between the Bank and one of its clients, on the recalculation of interest payments of a vehicle loan indexed to foreign currencies. The Supreme Court's ruling in this case confirmed the precedent of the Court's previous rulings from 2012, in cases where retroactive calculations under certain circumstances were also disputed. Following this ruling, the Bank commenced work on new recalculations of loans which fall under the precedent of the Court's ruling with emphasis on loans to individuals. The Bank's priority is to resolve this matter for its clients and the Bank has allocated resources to this effort to back its strong commitment. Further Supreme Court rulings in the coming months are expected to provide further clarification on this issue of foreign exchange indexed loans.

Regular instalments of the Bank's secured bonds, denominated in foreign currencies and issued to LBI hf., are scheduled for the years 2014-2018. At the end of the second quarter of 2013 the Bank maintains its strong liquidity position in foreign currencies and the Bank's concentration of currency risk is well within acceptable risk limits. It is, however, important for the Bank to maintain a strong liquidity position in foreign currencies and extend the maturity profile of its foreign currency funding in a timely manner, through renegotiations or refinancing.

Due to capital controls, the Group's ability to mitigate the risk from ISK related currency fluctuations is limited. However, the Group has taken various measures to decrease its overall currency risk and expects future currency risk levels to be within acceptable limits.

## Outlook

The Bank's macroeconomic forecast from last May assumes 2.0% GDP growth in 2013. The forecast has been scaled down since the forecast from November 2012, which assumed 2.4% GDP growth in 2013. Expectations of economic growth in 2013 have somewhat diminished due to less growth in private consumption and low investment levels. The latest forecast from Statistics Iceland predicts 0.8% economic growth in Q1 which is in line with this trend.

The Bank's core operations are sound and have been improving in recent years. Processes are being revised on a continuous basis to improve efficiency and customer relationship management. The Group has a strong equity and liquidity base and is, therefore, in a position to deal with the challenges ahead and maintain its strong financial position. The political and legal environment in Iceland as well as the risk associated with the country's current capital controls continue, however, to pose uncertainty.

## Other issues

At the Annual General Meeting of the Bank for the operating year 2012 held on 17 April 2013, shareholders approved the Board's proposal to pay dividends to shareholders in the amount of ISK 0.42 per share for the year 2012, or what amounts to 39% of net profit for the year 2012. Dividends shall be paid to parties registered in the shareholders' registry at 30 September 2013 and payment will be made on 1 October 2013. The dividend payment amounts to ISK 10,080 million.

## Statement by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Landsbankinn hf. for the first six months ended 30 June 2013 have been prepared on a going-concern basis in accordance with International Accounting Standard (IAS) 34 Interim Financial Reporting as adopted by the EU.

It is our opinion that the Condensed Consolidated Interim Financial Statements of Landsbankinn hf. give a true and fair view of the consolidated financial performance of the Group for the first six months of 2013, its consolidated financial position as at 30 June 2013 and its consolidated cash flows for the first six months of 2013.

Furthermore, in our opinion, the Condensed Consolidated Interim 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 of the Bank and Chief Executive Officer hereby endorse the Condensed Consolidated Interim Financial Statements of Landsbankinn hf. for the first six months ended 30 June 2013.

Reykjavík, 29 August 2013

Board of Directors

Tryggvi Pálsson
Chairman

Eva Sóley Guðbjörnsdóttir

Helga Björk Eiríksdóttir

Danielle Pamela Neben

Jón Sigurðsson

Kristján Þ. Davíðsson

Þórdís Ingadóttir

CEO

Steinþór Pálsson

# Independent Auditor's Review Report

**To the Board of Directors and Shareholders of Landsbankinn hf.**

We have reviewed the accompanying Condensed Consolidated Statement of Financial Position of Landsbankinn hf. as at 30 June 2013 and the related Condensed Consolidated Income Statement, Changes in Equity and Condensed Cash Flows for the six-month period then ended and a summary of significant accounting policies and other explanatory information. Management is responsible for the preparation and presentation of this condensed consolidated interim financial information in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU. Our responsibility is to express a conclusion on this Condensed Consolidated Interim Financial information based on our review.

**Scope of Review**

We conducted our review in accordance with International Standard on Review Engagements 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity. A review of interim financial information consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

**Conclusion**

Based on our review, nothing has come to our attention that causes us to believe that the accompanying condensed consolidated interim financial information is not prepared, in all material respects, in accordance with IAS 34 *Interim Financial Reporting* as adopted by the EU.

Reykjavík, 29 August 2013.

***KPMG ehf.***

Helgi F. Árnarson

Sigríður Helga Sveinsdóttir

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# Condensed Consolidated Statement of Financial Position as at 30 June 2013

| Notes | | 30.6.2013 | 31.12.2012 |
|---|---|---|---|
| | **Assets** | | |
| | Cash and balances with Central Bank | 23,643 | 25,898 |
| 5, 21 | Bonds and debt instruments | 278,386 | 228,208 |
| 5 | Equities and equity instruments | 34,029 | 36,881 |
| 5, 6 | Derivative instruments | 124 | 1,043 |
| 7, 21 | Loans and advances to financial institutions | 70,671 | 64,349 |
| 8, 21 | Loans and advances to customers | 665,411 | 666,087 |
| | Investments in equity-accounted associates | 11,989 | 15,528 |
| | Property and equipment | 5,534 | 6,776 |
| | Intangible assets | 449 | 541 |
| | Deferred tax assets | 0 | 48 |
| 9 | Other assets | 16,123 | 14,108 |
| | | **1,106,359** | **1,059,467** |
| 10 | Assets classified as held for sale | 19,735 | 25,320 |
| | **Total assets** | **1,126,094** | **1,084,787** |
| | **Liabilities** | | |
| | Due to financial institutions and Central Bank | 110,025 | 98,718 |
| | Deposits from customers | 448,931 | 421,058 |
| 6 | Derivative instruments and short positions | 7,044 | 9,438 |
| | Tax liabilities | 3,237 | 0 |
| 11, 21 | Secured bonds | 297,459 | 221,791 |
| 5,11 | Contingent bond | 0 | 87,474 |
| | Other liabilities | 28,546 | 20,249 |
| | | **895,242** | **858,728** |
| | Liabilities associated with assets classified as held for sale | 1,022 | 893 |
| | **Total liabilities** | **896,264** | **859,621** |
| | **Equity** | | |
| | Share capital | 23,500 | 24,000 |
| | Share premium | 119,707 | 123,898 |
| | Reserves | 9,070 | 5,053 |
| | Retained earnings | 77,615 | 72,120 |
| | **Total equity attributable to owners of the Bank** | **229,892** | **225,071** |
| | Non-controlling interests | (62) | 95 |
| | **Total equity** | **229,830** | **225,166** |
| | **Total liabilities and equity** | **1,126,094** | **1,084,787** |

The accompanying notes are an integral part of these Condensed Consolidated Interim Financial Statements.

All amounts are in ISK million

# Condensed Consolidated Income Statement for the six months ended 30 June 2013

| Notes | | 2013<br>1.4-30.6 | 2012<br>1.4-30.6 | 2013<br>1.1-30.6 | 2012<br>1.1-30.6 |
|---|---|---|---|---|---|
| | Interest income | 13,711 | 18,306 | 31,626 | 35,075 |
| | Interest expense | (6,593) | (8,286) | (14,629) | (16,502) |
| 13 | **Net interest income** | **7,118** | **10,020** | **16,997** | **18,573** |
| 14 | Net adjustments to loans and advances acquired at deep discount | 11,352 | 3,610 | 14,945 | 11,172 |
| 14, 34 | Net impairment loss | (8,035) | (5,151) | (8,694) | (6,439) |
| 5 | Fair value change of contingent bond | 0 | (2,251) | 1,319 | (8,198) |
| | **Net adjustments in valuation** | **3,317** | **(3,792)** | **7,570** | **(3,465)** |
| | **Net interest income after net adjustments in valuation** | **10,435** | **6,228** | **24,567** | **15,108** |
| | Fee and commission income | 2,427 | 1,836 | 4,574 | 3,676 |
| | Fee and commission expense | (830) | (746) | (1,614) | (1,584) |
| | **Net fee and commission income** | **1,597** | **1,090** | **2,960** | **2,092** |
| 15 | Net gain on financial assets designated as at fair value through profit or loss | 375 | 1,429 | 2,907 | 3,806 |
| 16 | Net gain on financial assets and liabilities held for trading | 711 | 112 | 1,291 | 1,227 |
| 17 | Net foreign exchange gain (loss) | 16 | (1,280) | 1,188 | 836 |
| | Other income and (expenses) | 1,708 | 269 | 1,981 | 491 |
| | **Other net operating income** | **2,810** | **530** | **7,367** | **6,360** |
| | **Total operating income** | **14,842** | **7,848** | **34,894** | **23,560** |
| 18 | Salaries and related expenses | 3,122 | 3,364 | 10,986 | 6,596 |
| | Other operating expenses | 2,109 | 2,331 | 4,198 | 4,516 |
| | Depreciation and amortisation | 214 | 181 | 423 | 361 |
| | Contribution to the Depositors' and Investors' Guarantee Fund | 270 | 204 | 538 | 554 |
| | Acquisition-related costs | 0 | 0 | 45 | 0 |
| | **Total operating expenses** | **5,715** | **6,080** | **16,190** | **12,027** |
| | Share of profit of equity-accounted associates, net of income tax | 866 | 673 | 1,127 | 673 |
| | **Profit before tax** | **9,993** | **2,441** | **19,831** | **12,206** |
| 19 | Income tax | (2,362) | (400) | (4,121) | (2,277) |
| | Tax on liabilities of financial institutions | (95) | (205) | (185) | (536) |
| | **Profit for the period from continuing operations** | **7,536** | **1,836** | **15,525** | **9,393** |
| | Profit for the period from discontinued operations, net of income tax | 0 | 2,312 | 0 | 2,484 |
| | **Profit for the period** | **7,536** | **4,148** | **15,525** | **11,877** |
| | **Profit for the period attributable to:** | | | | |
| | **Owners of the Bank** | | | | |
| | Profit for the period from continuing operations | 7,554 | 1,836 | 15,577 | 9,393 |
| | Profit for the period from discontinued operations | 0 | 2,302 | 0 | 2,456 |
| | **Profit for the period attributable to owners of the Bank** | **7,554** | **4,138** | **15,577** | **11,849** |
| | **Non-controlling interests** | | | | |
| | (Loss) profit for the period from continuing operations | (18) | 10 | (52) | 28 |
| | **(Loss) profit for the period attributable to non-controlling interests** | **(18)** | **10** | **(52)** | **28** |
| | **Profit for the period** | **7,536** | **4,148** | **15,525** | **11,877** |

The accompanying notes are an integral part of these Condensed Consolidated Interim Financial Statements.

All amounts are in ISK million

# Condensed Consolidated Statement of Changes in Equity for the six months ended 30 June 2013

| Notes | Change in equity for the six months ended 30 June 2013 | Share capital | Share premium | Own shares reserve | Statutory reserve | Share-based payment reserve | Retained earnings | Total | Non-controlling interests | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Attributable to owners of the Bank | | | | | | | | |
| | Balance at 1 January 2013 | 24,000 | 123,898 | | 5,053 | | 72,120 | 225,071 | 95 | 225,166 |
| | Profit for the period | | | | | | 15,577 | 15,577 | (52) | 15,525 |
| 12 | Equity classified as liability to purchase own shares | | | (4,691) | | | | (4,691) | | (4,691) |
| 12 | Purchase of own shares | (500) | (4,191) | 4,691 | | | | 0 | | 0 |
| 12 | Recognition of equity-settled employee share-based payments | | | | | 4,017 | | 4,017 | | 4,017 |
| | Dividends declared | | | | | | (10,080) | (10,080) | | (10,080) |
| | Decrease in non-controlling interests due to sale of subsidiaries | | | | | | | 0 | (105) | (105) |
| | **Balance at 30 June 2013** | **23,500** | **119,707** | **0** | **5,053** | **4,017** | **77,615** | **229,892** | **(62)** | **229,832** |
| | **Change in equity for the six months ended 30 June 2012** | | | | | | | | | |
| | Balance at 1 January 2012 | 24,000 | 123,898 | | 3,781 | | 47,952 | 199,631 | 613 | 200,244 |
| | Profit for the period | | | | | | 11,849 | 11,849 | 28 | 11,877 |
| | Decrease in non-controlling interests due to sale of subsidiaries | | | | | | | 0 | (99) | (99) |
| | **Balance at 30 June 2012** | **24,000** | **123,898** | **0** | **3,781** | **0** | **59,801** | **211,480** | **542** | **212,022** |

The accompanying notes are an integral part of these Condensed Consolidated Interim Financial Statements.

All amounts are in ISK million

## Condensed Consolidated Statement of Cash Flows for the six months ended 30 June 2013

| Notes | | 2013<br>1.1-30.6 | 2012<br>1.1-30.6 |
|---|---|---|---|
| | **Operating activities** | | |
| | Profit for the period | 15,525 | 11,877 |
| | Adjustments for non-cash items included in profit for the period | (23,852) | (20,748) |
| | Changes in operating assets and liabilities | (22,980) | 52,181 |
| | Interest received | 21,586 | 25,405 |
| | Interest paid | (4,218) | (4,811) |
| | Dividends received | 425 | 502 |
| | Income tax paid | - | (537) |
| | **Net cash (used in) from operating activities** | **(13,514)** | **63,869** |
| | **Investing activities** | | |
| | Cash and cash equivalents included in net assets acquired | (19) | (3) |
| | Proceeds of shares in equity-accounted associates | 5,593 | (895) |
| | Purchase of property and equipment | (611) | (104) |
| | Proceeds from sale of property and equipment | 1,133 | 21 |
| | Purchase of intangible assets | (48) | (67) |
| | Sale of subsidiaries | 202 | 9,457 |
| | **Net cash from (used in) investing activities** | **6,250** | **8,409** |
| | **Financing activities** | | |
| | Proceeds from new long-term debt | 1,160 | - |
| | Repayment of long-term debt | (2,201) | (73,388) |
| | **Net cash used in financing activities** | **(1,041)** | **(73,388)** |
| | Net change in cash and cash equivalents | (8,305) | (1,110) |
| | Cash and cash equivalents at the beginning of the period | 32,554 | 13,625 |
| | Effect of exchange rate changes on cash and cash equivalents held | 379 | (358) |
| | **Cash and cash equivalents at 30 June** | **24,628** | **12,157** |
| | **Investing and financing activities not affecting cash flows** | | |
| | Sale of financial investments | - | - |
| | Provisional amount of the bond to be issued by the Icelandic State Treasury | - | (19,198) |
| | Bonds and debt instruments | - | 19,198 |
| | Assets classified as held for sale | - | - |

The accompanying notes are an integral part of these Condensed Consolidated Interim Financial Statements.

All amounts are in ISK million

## Condensed Consolidated Statement of Cash Flows for the six months ended 30 June 2013

| Notes | | 2013<br>1.1-30.6 | 2012<br>1.1-30.6 |
|---|---|---|---|
| | **Adjustments for non-cash items included in profit for the period** | | |
| 13 | Net interest income | (16,997) | (18,572) |
| 14 | Net adjustments to loans and advances acquired at deep discount | (14,945) | (11,172) |
| 14 | Net impairment loss | 8,694 | 6,439 |
| 5 | Fair value change of contingent bond | (1,319) | 8,198 |
| 15 | Net (gain) on financial assets designated as at fair value through profit or loss | (2,907) | (3,806) |
| 16 | Net (gain) on financial assets and liabilities held for trading | (1,291) | (1,227) |
| | Net gain on assets classified as held for sale | - | (2,484) |
| 17 | Net foreign exchange gain | (1,567) | (478) |
| | Gain on sale of property and equipment | (277) | (16) |
| | Gain on repossessed collateral | (601) | (130) |
| | Depreciation and amortisation | 423 | 361 |
| | Share of profit of equity-accounted associates, net of income tax | (1,127) | (673) |
| | Share of profit of sale of associates | (935) | - |
| | Recognition of equity-settled employee share-based payments | 4,691 | - |
| 19 | Income tax | 4,121 | 2,277 |
| 19 | Tax on liabilities of financial institutions | 185 | 536 |
| | | **(23,852)** | **(20,747)** |
| | **Changes in operating assets and liabilities** | | |
| | Change in reserve requirement with Central Bank | (3,012) | (5,544) |
| | Change in bonds and equities | (45,166) | 52,138 |
| | Change in loans and advances to financial institutions | (10,795) | 37,316 |
| | Change in loans and advances to customers | 4,093 | 11,407 |
| | Change in other assets | (5,326) | 5,604 |
| | Change in assets classified as held for sale | 10,151 | (4,488) |
| | Change in due to financial institutions and Central Bank | 11,939 | (22,476) |
| | Change in deposits from customers | 23,469 | (13,900) |
| | Change in repossessed collateral | 1,889 | (1,812) |
| | Change in other liabilities | (7,061) | (7,022) |
| | Change in liabilities associated with assets classified as held for sale | (3,161) | 960 |
| | | **(22,980)** | **52,181** |
| | **Cash and cash equivalents is specified as follows:** | | |
| | Cash and unrestricted balances with Central Bank | 18,660 | 8,401 |
| | Bank accounts with financial institutions | 5,968 | 3,755 |
| | **Cash and cash equivalents at the end of the period** | **24,628** | **12,157** |

The accompanying notes are an integral part of these Condensed Consolidated Interim Financial Statements.

All amounts are in ISK million

# Notes to the Condensed Consolidated Interim Financial Statements

# Notes to the Condensed Consolidated Interim Financial Statements

## 1. Reporting entity

Landsbankinn hf. (hereinafter referred to as the "Bank" or "Landsbankinn") was founded on 7 October 2008 by the Ministry of Finance on behalf of the Icelandic State Treasury, thereby taking over part of the domestic operations of LBI hf. (formerly Landsbanki Íslands hf.).

The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank operates in accordance with Act No. 161/2002 on Financial Undertakings and is licensed by the Financial Supervisory Authority in Iceland (FME) as a commercial bank. The Bank is subject to supervision of the FME in accordance with Act No. 87/1998 on Official Supervision of Financial Activities. The registered address of the Bank's office is Austurstræti 11, 155 Reykjavík.

The Condensed Consolidated Interim Financial Statements of the Bank for the six months ended 30 June 2013 include the Bank and its subsidiaries (collectively referred to as the "Group" and individually as "Group entities"). The Group's primary lines of business are corporate and personal banking, investment banking, asset management and other related services. The Group operates solely in Iceland.

The issue of these Condensed Consolidated Interim Financial Statements was authorised by the Board of Directors and the CEO of the Bank on 29 August 2013.

## 2. Basis of preparation

### Statement of compliance

These Condensed Consolidated Interim Financial Statements for the six months ended 30 June 2013 have been prepared in accordance with International Accounting Standard (IAS) 34 Interim Financial Reporting as adopted by the European Union.

The Condensed Consolidated Interim Financial Statements do not include all the information required for full annual financial statements and should be read in conjunction with the Consolidated Financial Statements of the Group as at and for the year ended 31 December 2012, which are available on the Bank's website www.landsbankinn.is.

### Basis of measurement

The Condensed Consolidated Interim Financial Statements have been prepared on a historical cost basis except for the following:
• Financial assets and liabilities classified as held for trading are measured at fair value;
• Financial assets and liabilities designated as at fair value through profit or loss are measured at fair value;
• Non-current assets and disposal groups classified as held for sale are measured at the lower of cost 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.

In preparing the Condensed Consolidated Interim Financial Statements, the significant judgements made by management in applying the Group's accounting policies and the key sources of estimation uncertainty were the same as those that applied to the Consolidated Financial Statements as at and for the year ended 31 December 2012.

## 3. Significant accounting policies

The Condensed Consolidated Interim Financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances. The accounting policies applied by the Group in the Condensed Consolidated Interim Financial Statements are the same as those applied by the Group in its Consolidated Financial Statements as at and for the year ended 31 December 2012. The accounting policies applied have been applied consistently to all periods presented.

### 3. Significant accounting policies (continued)

The Group has adopted 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. The adoption did not result in any significant effect on the Group's financial results.

The Group has adopted amendments to IFRS 7, Offsetting Financial Assets and Financial Liabilities, which clarifies that when an entity currently has a legally enforceable right to set-off financial assets and financial liabilities, it is required to disclose certain information about the effect or potential effect on an entity's financial position resulting from netting arrangements. The adoption did not result in any significant effect on the Group's financial results.

### 4. Operating segments

The business segments are presented 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 four main business segments at the end of the reporting period:

• **Personal Banking** provides financial services through the Bank's branch network to individuals and to small and medium-size businesses.
• **Corporate Banking** provides financial services to large and medium-size corporate clients. It provides restructuring solutions to corporate clients who have defaulted on their loans and can be returned to viability.
• **Markets** provide brokerage services in securities, foreign currencies and derivatives, sale of securities issues, money market lending and advisory services. Markets provides a range of wealth and asset management products and services for individuals, corporations and institutional investors. Horn fjárfestingarfélag and Landsbréf, subsidiaries of the Bank, are included in Markets.
• **Treasury** incorporates unallocated capital, funding, liquidity and interbank functions for the Bank as well as management of the Group's market risk.

Support Functions comprise of Finance (excluding Treasury), Risk Management, Corporate Development & HR and Operations & IT.

Reconciliation consists of eliminations and transactions that cannot be allocated to any one segment.

Administrative expenses of the Group's Support Functions are allocated to appropriate business segments based on the underlying cost drivers. Expenses are allocated to the business units at market price level. Support Functions supply services to business units, and transactions are settled at unit prices or on an arm's-length basis; if possible, on the basis of consumption and activity.

The following table summarises 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 periods from 1 January to 30 June 2013 and 2012.

## 4. Operating segments (continued)

| 1 January - 30 June 2013 | Personal Banking | Corporate Banking | Markets | Treasury | Support Functions | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 8,706 | 7,473 | 206 | 1,555 | (41) | (902) | **16,997** |
| Net adjustments in valuation | (3,585) | 11,013 | - | (139) | 281 | - | **7,570** |
| Net fee and commission income | 1,308 | 407 | 1,386 | 106 | (97) | (150) | **2,960** |
| Other net operating income | (579) | (743) | 1,501 | 5,814 | 472 | 902 | **7,367** |
| **Total operating income (expense)** | **5,850** | **18,150** | **3,093** | **7,336** | **615** | **(150)** | **34,894** |
| Operating expenses | (4,761) | (782) | (1,118) | (684) | (8,995) | 150 | **(16,190)** |
| Share of profit of equity-accounted associates, net of income tax | (35) | - | - | 1,195 | (33) | - | **1,127** |
| **Profit (loss) before cost allocation and tax** | **1,054** | **17,368** | **1,975** | **7,847** | **(8,413)** | **0** | **19,831** |
| Cost allocated from support functions to business segments | (3,195) | (1,364) | (590) | (400) | 5,549 | - | **0** |
| **Profit (loss) before tax** | **(2,141)** | **16,004** | **1,385** | **7,447** | **(2,864)** | **0** | **19,831** |
| | | | | | | | |
| Net revenue (expenses) from external customers | 3,018 | 25,550 | 2,925 | 2,949 | 601 | - | **35,043** |
| Net revenue (expenses) from other segments | 2,832 | (7,400) | 168 | 4,387 | 13 | - | **0** |
| **Total operating income (expense)** | **5,850** | **18,150** | **3,093** | **7,336** | **614** | **0** | **35,043** |
| | | | | | | | |
| **At 30 June 2013** | | | | | | | |
| **Total assets** | **499,165** | **402,609** | **63,515** | **519,203** | **31,687** | **(390,085)** | **1,126,094** |
| **Total liabilities** | **443,973** | **321,764** | **56,168** | **432,757** | **31,687** | **(390,085)** | **896,264** |
| **Allocated capital** | **55,192** | **80,845** | **7,348** | **86,445** | **0** | **0** | **229,830** |

| 1 January - 30 June 2012 | Personal Banking | Corporate Banking | Markets | Treasury | Support Functions | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 8,961 | 9,285 | (77) | 1,321 | (478) | (439) | **18,573** |
| Net adjustments in valuation | (7,312) | 257 | - | (22) | 132 | 3,480 | **(3,465)** |
| Net fee and commission income | 1,151 | 141 | 1,121 | 106 | (164) | (263) | **2,092** |
| Other net operating income | (71) | 487 | 1,364 | 4,342 | 131 | 107 | **6,360** |
| **Total operating income (expense)** | **2,729** | **10,170** | **2,408** | **5,747** | **(379)** | **2,885** | **23,560** |
| Operating expenses | (3,522) | (647) | (700) | (929) | (6,446) | 217 | **(12,027)** |
| Share of profit of equity-accounted associates, net of income tax | 267 | - | - | 406 | - | - | **673** |
| **Profit (loss) before cost allocation and tax** | **(526)** | **9,523** | **1,708** | **5,224** | **(6,825)** | **3,102** | **12,206** |
| Cost allocated from support functions to business segments | (3,095) | (1,158) | (361) | (585) | 5,199 | - | **0** |
| **Profit (loss) before tax** | **(3,621)** | **8,365** | **1,347** | **4,639** | **(1,626)** | **3,102** | **12,206** |
| | | | | | | | |
| Net revenue (expenses) from external customers | 49 | 19,469 | 2,266 | (897) | (212) | - | **20,675** |
| Net revenue (expenses) from other segments | 2,680 | (9,299) | 142 | 6,643 | (166) | - | **0** |
| **Total operating income (expense)** | **2,729** | **10,170** | **2,408** | **5,746** | **(378)** | **0** | **20,675** |
| | | | | | | | |
| **At 30 June 2012** | | | | | | | |
| **Total assets** | **489,946** | **435,610** | **21,683** | **490,664** | **40,688** | **(430,018)** | **1,048,573** |
| **Total liabilities** | **455,831** | **352,547** | **21,415** | **396,088** | **40,688** | **(430,018)** | **836,551** |
| **Allocated capital** | **34,115** | **83,063** | **268** | **94,576** | **0** | **0** | **212,022** |

All amounts are in ISK million

## Notes to the Condensed Consolidated Statement of Financial Position

### 5. 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 30 June 2013:

| 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 | 23,643 | - | - | - | - | 23,643 | 23,643 |
| Bonds and debt instruments | 112,762 | 133,570 | 32,054 | - | - | 278,386 | 278,386 |
| Equities and equity instruments | - | 3,251 | 30,778 | - | - | 34,029 | 34,029 |
| Derivative instruments | - | 124 | - | - | - | 124 | 124 |
| Loans and advances to financial institutions | 70,671 | - | - | - | - | 70,671 | 70,671 |
| Loans and advances to customers | 665,411 | - | - | - | - | 665,411 | 671,943 |
| Other financial assets | 9,700 | - | - | - | - | 9,700 | 9,700 |
| **Total** | **882,187** | **136,945** | **62,832** | **0** | **0** | **1,081,964** | **1,088,496** |
| | | | | | | | |
| **Financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | - | - | - | 110,025 | - | 110,025 | 97,319 |
| Deposits from customers | - | - | - | 448,931 | - | 448,931 | 448,577 |
| Derivative instruments and short positions | - | 7,044 | - | - | - | 7,044 | 7,044 |
| Secured bonds | - | - | - | 297,459 | - | 297,459 | 297,459 |
| Other financial liabilities | - | - | - | 13,045 | - | 13,045 | 13,045 |
| **Total** | **0** | **7,044** | **0** | **869,460** | **0** | **876,504** | **863,444** |

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 2012:

| 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 | 25,898 | - | - | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | 113,203 | 100,950 | 14,055 | - | - | 228,208 | 228,208 |
| Equities and equity instruments | - | 1,107 | 35,774 | - | - | 36,881 | 36,881 |
| Derivative instruments | - | 1,043 | - | - | - | 1,043 | 1,043 |
| Loans and advances to financial institutions | 64,349 | - | - | - | - | 64,349 | 64,349 |
| Loans and advances to customers | 666,087 | - | - | - | - | 666,087 | 674,417 |
| Other financial assets | 10,481 | - | - | - | - | 10,481 | 10,481 |
| **Total** | **880,018** | **103,100** | **49,829** | **0** | **0** | **1,032,947** | **1,041,277** |
| | | | | | | | |
| **Financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | - | - | - | 98,718 | - | 98,718 | 98,718 |
| Deposits from customers | - | - | - | 421,058 | - | 421,058 | 420,856 |
| Derivative instruments and short positions | - | 9,438 | - | - | - | 9,438 | 9,438 |
| Secured bonds | - | - | - | 221,791 | - | 221,791 | 221,791 |
| Contingent bond | - | - | - | - | 87,474 | 87,474 | 87,474 |
| Other financial liabilities | - | - | - | 14,369 | - | 14,369 | 14,369 |
| **Total** | **0** | **9,438** | **0** | **755,936** | **87,474** | **852,848** | **852,646** |

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

The fair value of financial assets and liabilities was determined based on the same valuation methods as those described in the Group's Consolidated Financial Statements as at and for the year ended 31 December 2012.

### Fair value hierarchy

The Group has used a valuation hierarchy for disclosure of inputs to valuation used to measure fair value. Fair value measurements of financial instruments are made on the basis of the following hierarchy:

• Level 1: Quoted prices are used for assets and liabilities traded in active markets, unadjusted quoted prices are used as the measurement of fair value.
• Level 2: Valuation technique based on observable input, the most recent transaction prices in combination with generally accepted valuation methods are used to measure fair value of shares and the yield of actively traded bonds with same duration is used as a benchmark for the valuation of bonds.
• Level 3: Valuation technique based on significant non-observable input. For unlisted shares and bonds where there are no market data available various generally accepted valuation techniques are used to measure fair value. Valuation using discounted cash flow or a comparison of peer companies' multiples are the most commonly used methods to calculate fair value of unlisted shares.

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 30 June 2013:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 101,210 | 54,370 | 10,044 | 165,624 |
| Equities and equity instruments | 8,924 | 2,157 | 22,948 | 34,029 |
| Derivative instruments | - | 124 | - | 124 |
| **Total** | **110,134** | **56,651** | **32,992** | **199,777** |

| Financial liabilities | | | | |
|---|---|---|---|---|
| Derivative instruments | - | 727 | - | 727 |
| Short positions | 6,317 | - | - | 6,317 |
| **Total** | **6,317** | **727** | **0** | **7,044** |

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 2012:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 63,751 | 40,643 | 10,611 | 115,005 |
| Equities and equity instruments | 4,212 | 2,792 | 29,877 | 36,881 |
| Derivative instruments | - | 1,043 | - | 1,043 |
| **Total** | **67,963** | **44,478** | **40,488** | **152,929** |

| Financial liabilities | | | | |
|---|---|---|---|---|
| Derivative instruments | - | 519 | - | 519 |
| Short positions | 8,919 | - | - | 8,919 |
| Contingent bond | - | - | 87,474 | 87,474 |
| **Total** | **8,919** | **519** | **87,474** | **96,912** |

During the period from 1 January to 30 June 2013 there were no transfers between Level 1, Level 2 or Level 3.

All amounts are in ISK million

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

The following tables show the reconciliation of fair value measurement in Level 3 for the six months ended 30 June 2013 and for the year 2012:

| 1 January - 30 June 2013 | Bonds and debt instruments | Equities and equity instruments | Total financial assets | Contingent bond |
|---|---|---|---|---|
| Carrying amount at 1 January 2013 | 10,611 | 29,877 | 40,488 | (87,474) |
| Total gains recognised in income statement | 259 | 1,441 | 1,700 | 6,212 |
| Change in contingent bond - liability to purchase own shares | - | - | - | (4,691) |
| Purchases | - | 53 | 53 | - |
| Sales | (436) | (8,423) | (8,859) | - |
| Settlements | (390) | - | (390) | 85,953 |
| **Carrying amount at 30 June 2013** | **10,044** | **22,948** | **32,992** | **0** |
| **1 January - 31 December 2012** | | | | |
| Carrying amount at 1 January 2012 | 11,603 | 28,259 | 39,862 | (60,826) |
| Total gains (losses) recognised in income statement | 462 | 5,061 | 5,523 | (26,648) |
| Purchases | - | 2,629 | 2,629 | - |
| Sales | (40) | (6,281) | (6,321) | - |
| Settlements | (1,414) | 209 | (1,205) | - |
| **Carrying amount at 31 December 2012** | **10,611** | **29,877** | **40,488** | **(87,474)** |

The following tables show the line items in the Consolidated Income Statement where the total gains (losses) were recognised during the six months ended 30 June 2013 and 30 June 2012, for fair value measurements in Level 3:

| 1 January - 30 June 2013 | Bonds and debt instruments | Equities and equity instruments | Contingent bond | Total |
|---|---|---|---|---|
| Fair value change of contingent bond | - | - | 1,319 | 1,319 |
| Interest expense | - | - | (623) | (623) |
| Net gain on financial assets designated as at fair value through profit or loss | 655 | 1,960 | - | 2,615 |
| Net foreign exchange gain (loss) | (396) | (519) | 5,516 | 4,601 |
| **Total** | **259** | **1,441** | **6,212** | **7,912** |
| **1 January - 30 June 2012** | | | | |
| Fair value change of contingent bond | - | - | (8,198) | (8,198) |
| Net gain on financial assets designated as at fair value through profit or loss | 598 | 1,590 | - | 2,188 |
| Net foreign exchange gain (loss) | (186) | (20) | - | (206) |
| **Total** | **412** | **1,570** | **(8,198)** | **(6,216)** |

### 6. Derivative instruments and short positions

| | 30.6.2013 | | | 31.12.2012 | | |
|---|---|---|---|---|---|---|
| | Notional | Fair value | | Notional | Fair value | |
| **Foreign exchange derivatives** | amount | Assets | Liabilities | amount | Assets | Liabilities |
| Currency forwards | 58,923 | 96 | 165 | 57,302 | 1,040 | 113 |
| Cross-currency interest rate swaps | 1,450 | - | 498 | 1,506 | - | 377 |
| | **60,373** | **96** | **663** | **58,808** | **1,040** | **490** |
| **Interest rate derivatives** | | | | | | |
| Total return swaps | 3,011 | 6 | 21 | 4,668 | 3 | 8 |
| | **3,011** | **6** | **21** | **4,668** | **3** | **8** |
| **Equity derivatives** | | | | | | |
| Total return swaps | 1,917 | 22 | 43 | 562 | - | 21 |
| | **1,917** | **22** | **43** | **562** | **0** | **21** |
| **Short positions - listed bonds** | - | - | 6,317 | - | - | 8,918 |
| **Total** | **65,301** | **124** | **7,044** | **64,038** | **1,043** | **9,438** |

The Group uses derivatives both for hedging and trading purposes.

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## 7. Loans and advances to financial institutions

| | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Bank accounts with financial institutions | 5,968 | 8,559 |
| Money market loans | 47,539 | 37,769 |
| Overdrafts | 5,736 | 7,726 |
| Other loans | 11,428 | 10,295 |
| **Total** | **70,671** | **64,349** |

## 8. Loans and advances to customers

| | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Public entities | 11,274 | 11,682 |
| Individuals | 208,688 | 207,608 |
| Corporations | 498,512 | 490,827 |
| Less: Allowance for impairment | (53,063) | (44,030) |
| **Total** | **665,411** | **666,087** |

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.

## 9. Other assets

| | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Unsettled securities trading | 650 | 1,877 |
| Receivable from LBI hf. | 556 | 465 |
| Other accounts receivable | 3,445 | 3,090 |
| Claim on LBI hf. due to court ruling | 5,049 | 5,049 |
| Sundry assets | 6,423 | 3,627 |
| **Total** | **16,123** | **14,108** |

## 10. Assets classified as held for sale

| **Assets classified as held for sale** | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Repossessed collateral | 19,735 | 25,221 |
| Assets of disposal groups classified as held for sale | 0 | 99 |
| **Total** | **19,735** | **25,320** |

### 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 subsidiary Hömlur ehf.

| **Repossessed collateral** | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Carrying amount at the beginning of the period | 25,221 | 51,711 |
| Repossessed during the period | 4,525 | 12,171 |
| Disposed during the period | (9,293) | (37,979) |
| Impairment | (718) | (682) |
| **Carrying amount at the end of the period** | **19,735** | **25,221** |

### 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.

The profit (loss) for the period from discontinued operations which is presented in the Condensed 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.

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## 11. Secured bonds

| As at 30.6.2013 | Currency | Final maturity | Remaining principal | Contractual interest rate | Carrying amount |
|---|---|---|---|---|---|
| EUR Bonds | EUR | 9.10.2018 | 913 million | EURIBOR + 1.75/2.90 % | 147,464 |
| GBP Bonds | GBP | 9.10.2018 | 291 million | LIBOR + 1.75/2.90 % | 54,965 |
| USD Bonds | USD | 9.10.2018 | 756 million | LIBOR + 1.75/2.90 % | 93,866 |
| **Total issued bonds to LBI hf.** | | | | | **296,295** |

| As at 30.6.2013 | Currency | Final maturity | Remaining principal | Contractual interest rate | Carrying amount |
|---|---|---|---|---|---|
| LBANK CB 16 | ISK | 10.6.2016 | 1,160 | + 6.3 % | 1,164 |
| **Total covered bonds** | | | | | **1,164** |
| | | | | | |
| **Secured bonds total 30.6.2013** | | | | | **297,459** |

| As at 31.12.2012 | Currency | Final maturity | Remaining principal | Contractual interest rate | Carrying amount |
|---|---|---|---|---|---|
| EUR Bonds | EUR | 9.10.2018 | 649 million | EURIBOR + 1.75/2.90 % | 109,380 |
| GBP Bonds | GBP | 9.10.2018 | 205 million | LIBOR + 1.75/2.90 % | 42,397 |
| USD Bonds | USD | 9.10.2018 | 548 million | LIBOR + 1.75/2.90 % | 70,014 |
| **Total issued bonds to LBI hf.** | | | | | **221,791** |
| | | | | | |
| **Secured bonds total 31.12.2012** | | | | | **221,791** |

Pursuant to the provisions of the settlement agreement between the Bank, LBI hf. and the Icelandic State of 15 December 2009, the Bank issued the Contingent Bond to LBI hf. as Secured Bonds on 11 April 2013, the Secured Bonds being an additional consideration for the assets and liabilities transferred from LBI hf. to the Bank on 9 October 2008. The value of the bonds was contingent on the excess fair value of certain pools of assets as at 31 December 2012 over the future value of their acquisition price as at 9 October 2008, subject to specified adjustments.

On 12 October 2010 the Bank and LBI hf. signed a pledge agreement according to which the Bank pledged certain pools of loans to customers as collateral for Secured Bonds issued on 12 October 2010. The Bank must maintain a minimum cover ratio of 124.7% for the Secured Bonds. In addition, the Bank's original liability classified as Contingent Bond was issued as Secured Bonds on 11 April 2013 and on 10 June 2013 the Bank issued the Covered Bonds. Additional pledges of collateral were made in relation to these latest bond issues. See further details of the encumbered assets in Note 21.

The third-party valuation agent Deloitte UK LLP concluded its valuation of the specified assets in relation to the Contingent Bond, with the result that the Contingent Bond has been issued as Secured Bonds in the equivalent amount of ISK 92,000 million (ceiling amount), denominated in EUR (50%), USD (30%) and GBP (20%). LBI hf. has in return surrendered its entire holding in Landsbankinn to the Icelandic State and Landsbankinn.

During the first quarter of 2013 the Bank made a mandatory early redemption amount of ISK 2,201 million, due to a clause on Asset Disposition. The Bank shall redeem such part of the principal amount of the bonds as is equal to 50% of excess disposal amounts in regards to asset dispositions, subject to a maximum redemption amount.

On 10 June 2013 Landsbankinn issued its first series of covered bonds, LBANK CB 16 in the amount of ISK 1,220 million, the total size limit being ISK 10,000 million. The bonds are non-indexed with a 3 year fixed interest rate of 6.3%. The Bank simultaneously lowered its interest rates on non-indexed housing mortgages with a 3 year fixed interest rate from 7.5% to 7.3%. The covered bonds issue provides additional financing for the Bank's housing loan portfolio and reduces the Bank's fixed interest risk. Of the total issue of ISK 1,220 million ISK 1,160 million was sold to investors in the market. The remaining amount will be used for market making purposes in connection with listing of the bonds on NASDAQ OMX Iceland. Additional pledges of collateral were made in relation to the bond issue as explained in Note 21.

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## 12. Equity

On 11 April 2013 LBI hf. surrendered all its shareholding in Landsbankinn, resulting in the Icelandic State holding 98% of the shares issued by Landsbankinn and the Bank holding 2% of its own shares (i.e. 500 million shares). The Bank received the shares from LBI hf. with the obligation to allocate them to employees. The shareholders' meeting of the Bank, which was held on 17 July 2013, approved the allocation of the shares to the employees, who will receive around 1% of the shares, with the remaining shares being retained by the Bank for settlement of the tax obligations of its employees and salaries related expenses. In addition, employees are obliged to comply with specific requirements for the sale of the shares.

The Bank recognised the receipt of the 500 million own shares in equity as "Purchase of own shares" in the second quarter of 2013. However, in the first quarter of 2013 the Bank had already recognised its obligation to allocate the shares to its employees as equity-settled share-based payments. Thus, the Bank recognised in the first quarter of 2013 ISK 4,017 million as salary expenses in the income statement, with a corresponding amount recognised in equity as "Equity-settled employee share-based payments." In addition, the Bank recognised in the first quarter of 2013 ISK 674 million as salary related expenses in the income statement, with a corresponding amount recognised as a payable among other liabilities in the balance sheet. The employee share-based payments recognised in the financial statements are based on the allocation of the shares as decided by the shareholders' meeting of Landsbankinn, which was held on 17 July 2013.

## Notes to the Condensed Consolidated Income Statement

### 13. Net interest income

| Interest income | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Cash and balances with Central Bank | 296 | 248 | 629 | 386 |
| Bonds and debt instruments classified as loans and receivables | 1,375 | 1,156 | 2,747 | 2,234 |
| Loans and advances to financial institutions | 143 | 180 | 366 | 359 |
| Loans and advances to customers | 11,702 | 15,816 | 27,456 | 31,176 |
| Other interest income | 195 | 906 | 428 | 920 |
| **Total** | **13,711** | **18,306** | **31,626** | **35,075** |
| **Interest expense** | | | | |
| Due to financial institutions and Central Bank | (770) | (497) | (1,448) | (935) |
| Deposits from customers | (3,502) | (4,721) | (8,581) | (9,160) |
| Secured bonds | (2,316) | (3,047) | (4,585) | (6,342) |
| Other interest expense | (5) | (21) | (15) | (65) |
| **Total** | **(6,593)** | **(8,286)** | **(14,629)** | **(16,502)** |
| **Net interest income** | **7,118** | **10,020** | **16,997** | **18,573** |
| Interest spread (as the annualised ratio of net interest income to the average carrying amount of total assets during the period). | **2.6%** | **3.6%** | **3.1%** | **3.3%** |
| 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 period). | **3.8%** | **2.2%** | **4.5%** | **2.7%** |

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.

### 14. Net valuation change in loans and advances

| | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Net adjustments to loans and advances acquired at deep discount | 11,352 | 3,610 | 14,945 | 11,172 |
| Net impairment loss | (8,035) | (5,151) | (8,694) | (6,439) |
| **Total** | **3,317** | **(1,541)** | **6,251** | **4,733** |
| Individuals | (954) | 357 | (1,106) | (899) |
| Corporations | 4,271 | (1,898) | 7,357 | 5,632 |
| **Total** | **3,317** | **(1,541)** | **6,251** | **4,733** |

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

| | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Bonds and debt instruments | 621 | 580 | 936 | 622 |
| Equities and equity instruments | (246) | 849 | 1,971 | 3,184 |
| **Total** | **375** | **1,429** | **2,907** | **3,806** |

### 16. Net gain on financial assets and liabilities held for trading

| | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Bonds and debt instruments | 729 | 178 | 1,346 | 1,239 |
| Equities and equity instruments | 11 | (103) | 194 | 103 |
| Derivative instruments | (29) | 37 | (249) | (115) |
| **Total** | **711** | **112** | **1,291** | **1,227** |

for the six months ended 30 June 2013 20 All amounts are in ISK million

## 17. Net foreign exchange gain (loss)

| Assets | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Cash and balances with Central Bank | (14) | (60) | (85) | (1) |
| Bonds and debt instruments | (215) | (1,401) | (5,767) | 2,270 |
| Equities and equity instruments | 71 | (988) | (884) | 92 |
| Derivative instruments | 1,180 | (713) | 708 | 910 |
| Loans and advances to financial institutions | 823 | (5,943) | (1,789) | 152 |
| Loans and advances to customers | 1,101 | (7,626) | (11,235) | 720 |
| Other assets | 120 | 1,098 | (24) | 1,154 |
| **Total** | **3,066** | **(15,633)** | **(19,076)** | **5,297** |
| | | | | |
| **Liabilities** | | | | |
| Due to financial institutions and Central Bank | (72) | 587 | 888 | (515) |
| Deposits from customers | (474) | 2,538 | 3,527 | (895) |
| Secured bonds | (1,777) | 11,226 | 11,253 | (3,052) |
| Contingent bond | (727) | 1 | 4,596 | 1 |
| **Total** | **(3,050)** | **14,353** | **20,264** | **(4,461)** |
| | | | | |
| **Net foreign exchange gain (loss)** | **16** | **(1,280)** | **1,188** | **836** |

The foreign exchange differences which were recognised during the period 1 January to 30 June 2013 in the Condensed Consolidated Income Statement and arose on financial instruments not measured at fair value through profit or loss, amounted to a ISK 13,133 million loss for financial assets (1.1-30.6.2012: gain of ISK 2,025 million) and gain of ISK 15,668 million for financial liabilities (1.1-30.6.2012: loss of ISK 4,461 million).

## 18. Salaries and related expenses

| | 2013 1.4-30.6 | 2012 1.4-30.6 | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|---|---|
| Salaries | 2,340 | 2,625 | 4,776 | 5,186 |
| Contributions to defined contribution pension plans | 340 | 340 | 670 | 653 |
| Social security contributions, special financial activities tax on salaries and other expenses | 442 | 399 | 849 | 757 |
| **Total** | **3,122** | **3,364** | **6,295** | **6,596** |
| | | | | |
| Recognition of equity-settled employee share-based salaries | - | - | 4,017 | - |
| Recognition of equity-settled employee share-based social security contributions and special financial activities tax on salaries | - | - | 674 | - |
| **Total equity-settled employee share-based payments*** | **0** | **0** | **4,691** | **0** |
| | | | | |
| **Total Salaries and related expenses** | **3,122** | **3,364** | **10,986** | **6,596** |

* Further details on recognition of equity-settled employee share-based payments can be seen in Note 12.

## 19. 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% (2012: 20.0%). Special income tax on financial institutions at a rate of 6% on income tax base exceeding ISK 1,000 million in accordance with Act No. 165/2011 on Financial Activity Tax.

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

| | 2013 1.1-30.6 | 2012 1.1-30.6 |
|---|---|---|
| Current tax expense | (3,174) | (613) |
| Deferred tax expense | (947) | (1,664) |
| **Total** | **(4,121)** | **(2,277)** |

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

| | 1.1-30.6.2013 | | 1.1-30.6.2012 | |
|---|---|---|---|---|
| Profit before tax | | 19,831 | | 12,206 |
| Tax on liabilities of financial institutions | | (185) | | (536) |
| Profit before income tax | | 19,646 | | 11,670 |
| Income tax calculated using the domestic corporate income tax rate | 20.0% | (3,929) | 20.0% | (2,334) |
| Special income tax on financial institutions | 3.2% | (635) | 4.3% | (502) |
| Income not subject to tax | (1.7%) | 336 | (5.3%) | 620 |
| Non-deductable expenses | 0.3% | (50) | 1.1% | (123) |
| Other | (0.8%) | 157 | (0.5%) | 62 |
| **Effective income tax** | **21.0%** | **(4,121)** | **19.6%** | **(2,277)** |

All amounts are in ISK million

## Other notes

### 20. Litigation

The Group is exposed to litigations that arise from time to time in the ordinary course of business. The current litigations are expected to have immaterial effect on the Group's financial position.

In January 2013 a client of the Bank commenced litigation against the Bank claiming acknowledgement by the Court that he is not legally bound by a clause on consumer price index in a bond issued by himself to the Bank, alternatively that the Court confirms that the Bank is not entitled to revalue the principal amount of the bond on a monthly basis according to the consumer price index. Furthermore, the client claims confirmation by the Court that he is not legally bound by a clause in the same bond regarding the issuer's duty to pay a settlement fee. The client claims that the bond's clauses are illegal according to the Securities Transaction Act No. 108/2007 and EU Directive No. 2004/39/EB. The Bank will submit its defence and it is foreseeable that the case will be heard before the District Court of Reykjavík in the year 2013.

Following the rulings of the Supreme Court of Iceland in 2012, on interest calculations of loans illegally indexed to foreign currencies, the Bank has recalculated loans which the Bank presumes fall under the precedent of the rulings. The original method under Act No. 151/2010 on retroactive recalculations of interest payments, based on ISK interest rates determined by the Central Bank of Iceland, was ruled illegitimate in the specified circumstances, inter alia, as the lender had issued ultimate interest payment receipts. On 30 May 2013 the Supreme Court ruled, in case No. 50/2013 between the Bank and one of its clients, on recalculation of interest payments of a vehicle loan indexed to foreign currencies. The Supreme Court ruling in this case confirmed the precedent of the Court's previous rulings from 2012. Following this ruling the Bank commenced work on new recalculations of loans which fall under the precedent of the Court's ruling. Further Supreme Court rulings in the coming months are expected to provide further clarification on this issue.

### 21. Encumbered assets

| | Collateral pledged against | | | | |
|---|---|---|---|---|---|
| **At 30 June 2013** | **Covered Bonds** | **Issued to LBI hf.** | **Other*** | **Un-encumbered** | **Total** |
| Cash and balances with Central Bank | - | - | - | 23,643 | 23,643 |
| Bonds and debt instruments | - | 54,335 | 14,763 | 209,288 | 278,386 |
| Equities and equity instruments | - | - | - | 34,029 | 34,029 |
| Derivative instruments | - | - | - | 124 | 124 |
| Loans and advances to financial institutions | - | - | 9,677 | 60,994 | 70,671 |
| Loans and advances to customers | 1,471 | 376,712 | - | 287,228 | 665,411 |
| Investments in equity-accounted associates | - | - | - | 11,989 | 11,989 |
| Property and equipment | - | - | - | 5,534 | 5,534 |
| Intangible assets | - | - | - | 449 | 449 |
| Other assets | - | - | - | 16,123 | 16,123 |
| Assets classified as held for sale | - | - | - | 19,735 | 19,735 |
| **Total** | **1,471** | **431,047** | **24,440** | **669,136** | **1,126,094** |

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## 21. Encumbered assets (continued)

| At 31 December 2012 | Collateral pledged against: Issued to LBI hf. | Collateral pledged against: Other* | Un-encumbered | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | - | 17,821 | 210,387 | 228,208 |
| Equities and equity instruments | - | - | 36,881 | 36,881 |
| Derivative instruments | - | - | 1,043 | 1,043 |
| Loans and advances to financial institutions | - | 8,091 | 56,258 | 64,349 |
| Loans and advances to customers | 319,240 | - | 346,847 | 666,087 |
| Investments in equity-accounted associates | - | - | 15,528 | 15,528 |
| Property and equipment | - | - | 6,776 | 6,776 |
| Intangible assets | - | - | 541 | 541 |
| Deferred tax assets | - | - | 48 | 48 |
| Other assets | - | - | 14,108 | 14,108 |
| Assets classified as held for sale | - | - | 25,320 | 25,320 |
| **Total** | **319,240** | **25,912** | **739,635** | **1,084,787** |

*Other represents assets pledged as collateral to the Central Bank of Iceland to secure settlement in the Icelandic clearing systems, assets pledged as collateral to secure trading lines and credit support for ISDA master agreements and other pledges of similar nature.

## 22. Related party transactions

### (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 26.

### (b) Transactions with other related parties

Following the change in ownership of the Bank on 11 April 2013 and LBI hf. surrendered its holding in Landsbankinn, as described in Note 12, LBI hf. no longer meets the definition of a related party under IAS 24. The deposits from LBI hf. as at 31 December 2012 amounted to ISK 43,807 million and during the period from 1 January to 30 June 2012 the Bank recognised ISK 124 million from administrative services provided to LBI hf. based on a service level agreement.

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:

| Loans in ISK million | 2013: Balance at 30 June | 2013: Highest amount outstanding during the period | 2012: Balance at 31 December | 2012: Highest amount outstanding during the period |
|---|---|---|---|---|
| Key management personnel | 122 | 131 | 108 | 237 |
| Parties related to key management personnel | 133 | 223 | 176 | 333 |
| Associates | 48,363 | 61,198 | 44,544 | 72,677 |
| **Total** | **48,618** | **61,552** | **44,828** | **73,247** |

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

No 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.

## 22. Related party transactions (continued)

### (b) Transactions with other related parties (continued)

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

| | 2013 | | 2012 | |
|---|---|---|---|---|
| **Deposits in ISK million** | **Balance at 30 June** | **Highest amount outstanding during the period** | **Balance at 31 December** | **Highest amount outstanding during the period** |
| Key management personnel | 50 | 116 | 112 | 168 |
| Parties related to key management personnel | 41 | 116 | 56 | 166 |
| Associates | 11,865 | 17,653 | 18,432 | 36,667 |
| **Total** | **11,956** | **17,885** | **18,600** | **37,001** |

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

| **Guarantees in ISK million** | **Balance at 30 June 2013** | **Balance at 31 December 2012** |
|---|---|---|
| Associates | 187 | 507 |
| **Total** | **187** | **507** |

All of the above transactions were made in the ordinary course of business and substantially the same terms, including interest rates and collaterals, as those prevailing at the time for comparable transactions with the third party counterparties.

## 23. Events after the reporting period

The main events after the reporting period are as follows:

The shareholders' meeting of the Bank, which was held on 17 July 2013, approved the allocation of its own shares of 2% (i.e. 500 million shares). Employees will receive around 1% of the shares, with the remaining shares being retained by the Bank for settlement of the tax obligations of its employees and salaries related expenses. In addition, employees are obliged to comply with specific requirements for the sale of the shares.

## Capital management

### 24. Capital management

According to the EU Capital Requirements Directive the regulatory minimum capital requirement under Pillar I is 8% of risk weighted assets. The FME requires the Group to maintain a minimum core Tier 1 capital ratio of 12% unless revised by FME. In the latest Supervisory Review and Evaluation Process (SREP), based on year end 2011, the FME determined the Capital Adequacy Ratio to be at 19.5%, mainly because of uncertainty regarding currency loans. The Capital Adequacy Ratio is determined by the Group's calculation of its solvency need (ICAAP report) and SREP by the FME which is performed each year.

### 25. Capital base and capital adequacy ratio

The Group's equity at 30 June 2013 amounted to ISK 229.830 million (31.12.2012: ISK 225,166 million), equivalent to 20.4% (31.12.2012: 20.8%) of total assets, according to the Condensed Consolidated Statement of Financial Position. The Capital Adequacy Ratio, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 25.9% at 30 June 2013 (31.12.2012: 25.1%). According to the Act, this ratio may not fall below 8%.

| Capital base | 30.6.2013 | 31.12.2012 |
|---|---|---|
| Share capital | 23,500 | 24,000 |
| Share premium | 119,707 | 123,898 |
| Reserves | 9,070 | 5,053 |
| Retained earnings | 77,615 | 72,120 |
| Non-controlling interests | (62) | 95 |
| **Total equity** | **229,830** | **225,166** |
| Intangible assets | (449) | (541) |
| Deferred tax assets | - | (48) |
| **Tier 1 capital** | **229,381** | **224,577** |
| Deduction from original and additional own funds | (3,593) | (3,815) |
| **Capital base** | **225,788** | **220,762** |

| Risk-weighted assets | | |
|---|---|---|
| Credit risk | 669,829 | 679,516 |
| Market risk | 100,538 | 98,486 |
| Operational risk* | 101,393 | 101,393 |
| **Total risk-weighted assets** | **871,760** | **879,395** |

| | | |
|---|---|---|
| Tier 1 capital ratio | 26.3% | 25.5% |
| Capital adequacy ratio | 25.9% | 25.1% |

* The amounts are updated on a yearly basis.

All amounts are in ISK million

### 26. Maximum exposure to credit risk and concentration by industry sectors

The following tables show the Group's maximum credit risk exposure at 30 June 2013 and 31 December 2012. 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 Group uses the ISAT 08 industry classification for corporate customers.

| | | | | Corporations | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **At 30 June 2013** | **Financial institutions** | **Public entities*** | **Individuals** | **Fisheries** | **Construction and real estate companies** | **Services** | **Retail** | **Holding companies** | **Manu-facturing** | **Agriculture** | **ITC**** | **Other** | **Carrying amount** |
| Cash and balances with Central Bank | - | 23,643 | - | - | - | - | - | - | - | - | - | - | **23,643** |
| Bonds and debt instruments | 865 | 244,861 | - | - | 19,722 | - | - | 9,173 | - | - | - | 3,765 | **278,386** |
| Derivative instruments | 96 | - | 2 | - | - | - | - | - | - | - | - | 26 | **124** |
| Loans and advances to financial institutions | 70,671 | - | - | - | - | - | - | - | - | - | - | - | **70,671** |
| Loans and advances to customers | - | 11,074 | 192,740 | 133,694 | 117,262 | 42,839 | 39,613 | 68,736 | 25,039 | 11,828 | 19,347 | 3,239 | **665,411** |
| Other financial assets | 6,335 | 285 | 695 | 21 | 1,410 | 851 | 10 | - | 4 | 13 | 2 | 74 | **9,700** |
| **Total on-balance sheet exposure** | **77,967** | **279,863** | **193,437** | **133,715** | **138,394** | **43,690** | **39,623** | **77,909** | **25,043** | **11,841** | **19,349** | **7,104** | **1,047,935** |
| **Off-balance sheet exposure** | **3,352** | **16,271** | **24,659** | **11,313** | **20,308** | **14,269** | **9,798** | **913** | **2,942** | **1,610** | **2,934** | **654** | **109,023** |
| Financial guarantees and underwriting commitments | - | 155 | 522 | 1,398 | 4,142 | 5,716 | 1,018 | 34 | 871 | 39 | 742 | 43 | 14,680 |
| Undrawn loan commitments | 600 | 9,829 | - | 7,966 | 14,426 | 232 | 3,769 | 38 | 418 | 1,236 | 899 | 431 | 39,844 |
| Undrawn overdraft/credit card facilities | 2,752 | 6,287 | 24,137 | 1,949 | 1,740 | 8,321 | 5,011 | 841 | 1,653 | 335 | 1,293 | 180 | 54,499 |
| **Maximum exposure to credit risk** | **81,319** | **296,134** | **218,096** | **145,028** | **158,702** | **57,959** | **49,421** | **78,822** | **27,985** | **13,451** | **22,283** | **7,758** | **1,156,958** |
| Percentage of carrying amount | 7.0% | 25.6% | 18.9% | 12.5% | 13.7% | 5.0% | 4.3% | 6.8% | 2.4% | 1.2% | 1.9% | 0.7% | 100% |

* 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

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

| | | | | Corporations | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| At 31 December 2012 | Financial institutions | Public entities* | Individuals | Fisheries | Construction and real estate companies | Services | Retail | Holding companies | Manu-facturing | Agriculture | ITC** | Other | Carrying amount |
| Cash and balances with Central Bank | - | 25,898 | - | - | - | - | - | - | - | - | - | - | **25,898** |
| Bonds and debt instruments | 9,528 | 216,935 | - | - | 3 | - | - | 397 | 352 | - | - | 993 | **228,208** |
| Derivative instruments | 1,039 | - | - | - | - | - | - | - | - | - | - | 4 | **1,043** |
| Loans and advances to financial institutions | 64,349 | - | - | - | - | - | - | - | - | - | - | - | **64,349** |
| Loans and advances to customers | - | 11,576 | 195,047 | 142,952 | 104,928 | 52,700 | 42,019 | 60,009 | 25,665 | 10,199 | 19,413 | 1,579 | **666,087** |
| Other financial assets | 8,106 | 276 | 600 | 11 | 300 | 587 | - | - | 253 | - | 2 | 346 | **10,481** |
| **Total on-balance sheet exposure** | **83,022** | **254,685** | **195,647** | **142,963** | **105,231** | **53,287** | **42,019** | **60,406** | **26,270** | **10,199** | **19,415** | **2,922** | **996,066** |
| **Off-balance sheet exposure** | **4,054** | **14,215** | **28,146** | **14,374** | **30,797** | **11,465** | **8,612** | **1,147** | **2,361** | **1,049** | **2,496** | **46** | **118,762** |
| Financial guarantees and underwriting commitments | - | 95 | 463 | 1,731 | 23,149 | 2,123 | 1,685 | 208 | 584 | 39 | 552 | 35 | 30,664 |
| Undrawn loan commitments | 1,500 | 9,022 | 22 | 10,592 | 5,628 | 2,122 | 1,948 | 278 | 194 | 701 | 901 | - | 32,908 |
| Undrawn overdraft/credit card facilities | 2,554 | 5,098 | 27,661 | 2,051 | 2,020 | 7,220 | 4,979 | 661 | 1,583 | 309 | 1,043 | 11 | 55,190 |
| **Maximum exposure to credit risk** | **87,076** | **268,900** | **223,793** | **157,337** | **136,028** | **64,752** | **50,631** | **61,553** | **28,631** | **11,248** | **21,911** | **2,968** | **1,114,828** |
| Percentage of carrying amount | 7.8% | 24.1% | 20.1% | 14.1% | 12.2% | 5.8% | 4.5% | 5.5% | 2.6% | 1.0% | 2.0% | 0.3% | 100% |

* 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

## 27. Collaterals and loan-to-value by industry sectors

The loan-to-value (LTV) ratio expresses the maximum exposure of credit risk (carrying amount of loans and off-balance sheet items) as a percentage of the total appraised value of collateral. Loan to value is one of the key risk factors that is assessed when qualifying borrowers for a loan. The risk of default is always at the forefront of lending decisions, and the likelihood of a lender absorbing a loss in the foreclosure process increases as the collateral value decreases. A high LTV indicates that there is less cushion to protect against pricefalls or increases in the loan if repayments are not made and interest is added to the outstanding balance.

| | LTV Ratio - Fully collateralised | | | | | LTV Ratio - Partially collateralised | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **At 30 June 2013** | 0% - 25% | 25% - 50% | 50% - 75% | 75% - 100% | Total | >100% | Collateral value | Without Collaterals* | Allowance for impairment | Maximum exposure to credit risk |
| Financial institutions | - | - | - | - | - | 2 | 1 | 74.021 | - | 74.023 |
| Public entities | 27 | 60 | 224 | 582 | 893 | 5.876 | 652 | 20.776 | 200 | 27.345 |
| Individuals | 1.714 | 6.751 | 12.321 | 26.391 | 47.177 | 129.670 | 86.453 | 56.500 | 15.954 | 217.393 |
| Corporations | | | | | | | | | | |
| Fisheries | 942 | 16.746 | 15.690 | 26.369 | 59.747 | 84.024 | 61.505 | 8.510 | 7.278 | 145.003 |
| Construction and real estate companies | 461 | 2.598 | 1.932 | 10.003 | 14.994 | 116.722 | 58.827 | 15.999 | 10.149 | 137.566 |
| Holding companies | 503 | 804 | 1.459 | 2.284 | 5.050 | 53.208 | 37.365 | 16.696 | 5.286 | 69.669 |
| Retail | 72 | 1.098 | 2.039 | 4.109 | 7.318 | 39.576 | 17.075 | 8.737 | 6.220 | 49.410 |
| Services | 239 | 710 | 2.356 | 3.546 | 6.851 | 34.647 | 17.943 | 20.618 | 5.009 | 57.107 |
| Information, technology and communication | 11 | 34 | 63 | 90 | 198 | 18.383 | 7.781 | 4.217 | 516 | 22.281 |
| Manufacturing | 67 | 308 | 556 | 1.687 | 2.618 | 23.768 | 13.527 | 3.033 | 1.438 | 27.981 |
| Agriculture | 59 | 206 | 348 | 616 | 1.229 | 11.322 | 5.204 | 1.725 | 839 | 13.437 |
| Other | 2 | - | - | - | 2 | 2 | 1 | 4.061 | 174 | 3.890 |
| **Total** | **4.097** | **29.315** | **36.988** | **75.677** | **146.077** | **517.200** | **306.334** | **234.893** | **53.063** | **845.105** |
| **At 31 December 2012**** | | | | | | | | | | |
| Financial institutions | - | - | - | - | - | - | - | 68.404 | - | 68.404 |
| Public entities | 21 | 37 | 146 | 88 | 292 | 5.527 | 1.295 | 20.079 | 107 | 25.791 |
| Individuals | 5.967 | 10.099 | 13.137 | 16.648 | 45.851 | 118.312 | 76.849 | 71.591 | 12.560 | 223.194 |
| Corporations | | | | | | | | | | |
| Fisheries | 1.212 | 5.295 | 26.891 | 22.530 | 55.929 | 84.757 | 65.015 | 23.165 | 6.525 | 157.326 |
| Construction and real estate companies | 323 | 1.854 | 3.204 | 9.428 | 14.809 | 107.421 | 53.899 | 21.125 | 7.630 | 135.725 |
| Holding companies | 518 | 210 | 1.345 | 2.514 | 4.587 | 55.948 | 36.049 | 6.848 | 6.226 | 61.157 |
| Retail | 262 | 1.058 | 2.115 | 1.758 | 5.193 | 33.273 | 16.544 | 17.696 | 5.530 | 50.632 |
| Services | 874 | 883 | 11.666 | 1.721 | 15.144 | 32.602 | 17.051 | 19.635 | 3.217 | 64.164 |
| Information, technology and communication | 22 | 30 | 57 | 25 | 134 | 16.944 | 7.785 | 5.186 | 357 | 21.907 |
| Manufacturing | 93 | 363 | 951 | 1.317 | 2.725 | 17.872 | 11.942 | 8.567 | 1.138 | 28.026 |
| Agriculture | 409 | 277 | 608 | 149 | 1.444 | 7.202 | 4.648 | 3.150 | 547 | 11.249 |
| Other | 2 | - | 41 | - | 43 | 579 | 305 | 1.195 | 193 | 1.624 |
| **Total** | **9.703** | **20.107** | **60.161** | **56.178** | **146.151** | **480.437** | **291.382** | **266.641** | **44.030** | **849.199** |

*Credit card loans and overdraft on debit cards are assumed to be without collateral. If LTV is less than 100% the loan is considered fully secured. If LTV is greater than 100% the loan is partially collateralised and the respective collateral value is shown in the table.

**The comparative amounts have been restated due to an error in the year-end 2012 amounts previously disclosed. The amounts in this table are only of informative nature and do therefore not have any effect on the amounts reported by the Group in the income statement or statement of financial position.

All amounts are in ISK million

### 28. Collateral types

The following tables shows the collaterals used to mitigate credit risk.

| At 30 June 2013 | Real Estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1,650 | - | 28 | - | 89 | 1,767 |
| Individuals | 125,952 | 204 | 1,006 | 2,390 | 11,643 | 141,195 |
| Corporates | | | | | | |
| Fisheries | 6,922 | 117,858 | 181 | 6,807 | 13,760 | 145,528 |
| Construction and real estate companies | 78,998 | 201 | 1,083 | 372 | 2,021 | 82,675 |
| Holding companies | 5,333 | - | 175 | 35,926 | 5,586 | 47,020 |
| Retail | 11,028 | 8 | 315 | 1,501 | 13,231 | 26,083 |
| Services | 17,352 | 675 | 394 | 1,332 | 6,451 | 26,204 |
| ITC | 315 | - | 38 | 1,704 | 5,984 | 8,041 |
| Manufacturing | 8,120 | 273 | 300 | 5,813 | 2,955 | 17,461 |
| Agriculture | 3,890 | 15 | 6 | - | 2,774 | 6,685 |
| Other | 3 | - | - | - | 1 | 4 |
| **Total** | **259,563** | **119,234** | **3,526** | **55,845** | **64,495** | **502,663** |

| At 31 December 2012** | Real Estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1,575 | - | 32 | - | 87 | 1,694 |
| Individuals | 106,722 | 23 | 2,339 | 2,438 | 11,178 | 122,700 |
| Corporates | | | | | | |
| Fisheries | 5,395 | 112,632 | 136 | 2,564 | 13,754 | 134,481 |
| Construction and real estate companies | 77,958 | - | 1,162 | 340 | 1,979 | 81,439 |
| Holding companies | 4,751 | - | 210 | 27,304 | 5,574 | 37,839 |
| Retail | 11,515 | - | 219 | 627 | 13,416 | 25,777 |
| Services | 30,372 | 430 | 866 | 2,678 | 5,780 | 40,126 |
| ITC | 756 | 8 | 125 | 1,843 | 5,980 | 8,712 |
| Manufacturing | 7,179 | - | 385 | 5,409 | 2,946 | 15,919 |
| Agriculture | 3,203 | - | 4 | - | 2,774 | 5,981 |
| Other | 262 | - | 1 | - | 1 | 264 |
| **Total** | **249,688** | **113,093** | **5,479** | **43,203** | **63,469** | **474,932** |

*Other includes collaterals like financial claims, invoices, liquid assets, vehicles, machines, aircrafts and inventories.

**The comparative amounts have been restated due to an error in the year-end 2012 amounts previously disclosed. The amounts in this table are only of informative nature and do therefore not have any effect on the amounts reported by the Group in the income statement or statement of financial position.

for the six months ended 30 June 2013 29 All amounts are in ISK million

## 29. Loans and advances credit monitoring

The following tables shows the credit risk monitoring split on colour classification.

| Industry sectors as at 30 June 2013 | Green | Yellow | Orange | Red | Carrying amount |
|---|---|---|---|---|---|
| Financial institutions | 70,671 | - | - | - | 70,671 |
| Public entities | 10,447 | 549 | 78 | 1 | 11,075 |
| Individuals | 157,206 | 6,924 | 14,121 | 14,484 | 192,735 |
| Corporations | | | | | |
| Fisheries | 90,863 | 29,807 | 6,706 | 6,314 | 133,690 |
| Construction and real estate companies | 77,781 | 14,604 | 16,395 | 8,478 | 117,258 |
| Holding companies | 44,242 | 12,720 | 10,055 | 1,738 | 68,755 |
| Retail | 16,959 | 16,985 | 3,090 | 2,577 | 39,611 |
| Services | 25,913 | 9,319 | 4,299 | 3,306 | 42,837 |
| Information, technology and communication | 18,488 | 447 | 320 | 92 | 19,347 |
| Manufacturing | 17,774 | 2,901 | 1,853 | 2,510 | 25,038 |
| Agriculture | 10,323 | 885 | 409 | 210 | 11,827 |
| Other | 2,905 | 275 | 57 | 1 | 3,238 |
| **Total** | **543,572** | **95,416** | **57,383** | **39,711** | **736,082** |

| Industry sectors as at 31 December 2012 | Green | Yellow | Orange | Red | Carrying amount |
|---|---|---|---|---|---|
| Financial institutions | 64,349 | - | - | - | 64,349 |
| Public entities | 10,849 | 571 | 152 | 4 | 11,576 |
| Individuals | 149,615 | 9,641 | 19,010 | 16,781 | 195,047 |
| Corporations | | | | | |
| Fisheries | 102,319 | 29,130 | 3,006 | 8,497 | 142,952 |
| Construction and real estate companies | 55,038 | 16,190 | 18,318 | 15,382 | 104,928 |
| Holding companies | 32,668 | 10,867 | 8,028 | 8,446 | 60,009 |
| Retail | 18,643 | 16,075 | 2,470 | 4,831 | 42,019 |
| Services | 34,944 | 5,389 | 6,096 | 6,271 | 52,700 |
| Information, technology and communication | 18,853 | 192 | 202 | 166 | 19,413 |
| Manufacturing | 18,037 | 3,044 | 1,505 | 3,079 | 25,665 |
| Agriculture | 8,624 | 952 | 187 | 436 | 10,199 |
| Other | 346 | 657 | 471 | 105 | 1,579 |
| **Total** | **514,285** | **92,708** | **59,445** | **63,998** | **730,436** |

## 30. Credit quality of financial assets

| | Gross carrying amount | | | | | |
|---|---|---|---|---|---|---|
| **At 30 June 2013** | **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 | 23,643 | - | - | 23,643 | - | 23,643 |
| Bonds and debt instruments | 269,157 | 9,229 | - | 278,386 | - | 278,386 |
| Derivative instruments | 124 | - | - | 124 | - | 124 |
| Loans and advances to financial institutions | 70,671 | - | - | 70,671 | - | 70,671 |
| Loans and advances to customers | 466,918 | 71,533 | 180,023 | 718,474 | (53,063) | 665,411 |
| Other financial assets | 9,700 | - | - | 9,700 | - | 9,700 |
| **Total** | **840,213** | **80,762** | **180,023** | **1,100,998** | **(53,063)** | **1,047,935** |
| | | | | | | |
| **At 31 December 2012** | | | | | | |
| Cash and balances with Central Bank | 25,898 | - | - | 25,898 | - | 25,898 |
| Bonds and debt instruments | 219,009 | 9,199 | - | 228,208 | - | 228,208 |
| Derivative instruments | 1,043 | - | - | 1,043 | - | 1,043 |
| Loans and advances to financial institutions | 64,349 | - | - | 64,349 | - | 64,349 |
| Loans and advances to customers | 450,885 | 60,078 | 199,154 | 710,117 | (44,030) | 666,087 |
| Other financial assets | 10,481 | - | - | 10,481 | - | 10,481 |
| **Total** | **771,665** | **69,277** | **199,154** | **1,040,096** | **(44,030)** | **996,066** |

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

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## 31. Loans and advances neither past due nor individually impaired

The following tables show the credit quality, measured by rating grade, of loans and advances neither past due nor individually impaired.

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| **At 30 June 2013** | **10-7** | **6-4** | **3-1** | **0*** | **Unrated** | **Total** |
| Financial institutions | 64,209 | 6,462 | - | - | - | 70,671 |
| Public entities | 6,351 | 771 | 10 | - | 18 | 7,150 |
| Individuals | 6,674 | 106,680 | 24,733 | 495 | 4,705 | 143,287 |
| Corporations | | | | | | |
| Fisheries | 8,251 | 46,880 | 16,460 | 905 | - | 72,496 |
| Construction and real estate companies | - | 62,079 | 30,581 | 162 | 22 | 92,844 |
| Holding companies | - | 23,946 | 24,706 | 6 | 26 | 48,684 |
| Retail | - | 13,397 | 17,262 | 420 | 34 | 31,113 |
| Services | 713 | 21,645 | 7,953 | 55 | 261 | 30,627 |
| Information, technology and communication | 12 | 13,231 | 647 | 1 | - | 13,891 |
| Manufacturing | - | 16,271 | 2,126 | 114 | 375 | 18,886 |
| Agriculture | 215 | 3,451 | 948 | 4 | 7 | 4,625 |
| Other | - | 1,926 | 265 | - | 1,124 | 3,315 |
| **Total** | **86,425** | **316,739** | **125,691** | **2,162** | **6,572** | **537,589** |
| | | | | | | |
| **At 31 December 2012** | | | | | | |
| Financial institutions | 64,349 | - | - | - | - | 64,349 |
| Public entities | 2,357 | 73 | 4,866 | 10 | 88 | 7,394 |
| Individuals | 11,266 | 97,272 | 21,276 | 3,968 | 5,987 | 139,769 |
| Corporations | | | | | | |
| Fisheries | 391 | 31,227 | 47,886 | 3,442 | 19 | 82,965 |
| Construction and real estate companies | - | 41,960 | 20,039 | 7,129 | 248 | 69,376 |
| Holding companies | - | 23,468 | 13,203 | 1,174 | 477 | 38,322 |
| Retail | - | 26,667 | 2,775 | 223 | 248 | 29,913 |
| Services | 10,884 | 18,201 | 11,454 | 1,131 | 488 | 42,158 |
| Information, technology and communication | - | 239 | 13,724 | 30 | 26 | 14,019 |
| Manufacturing | 54 | 4,872 | 16,337 | 230 | 154 | 21,647 |
| Agriculture | 2 | 914 | 3,138 | 72 | 30 | 4,156 |
| Other | - | 534 | 3 | - | 630 | 1,166 |
| **Total** | **89,303** | **245,427** | **154,701** | **17,409** | **8,395** | **515,234** |

*Due to the accounting policies, loans and advances acquired at deep discount are not impaired even though the Group considers the obligor likely not to meet its obligations. Hence such loans can be defaulted but neither past due nor individually impaired.

## 32. 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 30 June 2013** | **Past due 1-5 days** | **Past due 6-30 days** | **Past due 31 - 60 days** | **Past due 61 - 90 days** | **Past due over 90 days** | **Gross carrying amount** |
|---|---|---|---|---|---|---|
| Public entities | - | 259 | - | - | 35 | 294 |
| Individuals | 4,111 | 10,530 | 3,552 | 1,930 | 8,807 | 28,930 |
| Corporations | 4,950 | 5,703 | 7,827 | 2,000 | 21,829 | 42,309 |
| **Total** | **9,061** | **16,492** | **11,379** | **3,930** | **30,671** | **71,533** |
| | | | | | | |
| **At 31 December 2012** | | | | | | |
| Public entities | - | 2 | 1 | - | 19 | 22 |
| Individuals | 115 | 7,545 | 3,156 | 1,487 | 11,450 | 23,753 |
| Corporations | 1,052 | 4,570 | 2,134 | 1,262 | 27,285 | 36,303 |
| **Total** | **1,167** | **12,117** | **5,291** | **2,749** | **38,754** | **60,078** |

All amounts are in ISK million

## 33. Loans and advances by industry sectors

| At 30 June 2013 | Gross carrying amount | Gross not individually impaired | Collective allowance | Individually impaired – Of which performing – Gross carrying amount | Individually impaired – Of which performing – Individual allowance | Individually impaired – Of which non-performing* – Gross carrying amount | Individually impaired – Of which non-performing* – Individual allowance | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Financial institutions | 70,671 | 70,671 | - | - | - | - | - | 70,671 |
| Public entities | 11,274 | 7,445 | 105 | 3,712 | 88 | 117 | 7 | 11,074 |
| Individuals | 208,688 | 172,216 | 2,924 | 24,151 | 6,515 | 12,322 | 6,516 | 192,734 |
| Corporations | | | | | | | | |
| Fisheries | 140,968 | 82,121 | 2,215 | 57,013 | 3,782 | 1,834 | 1,281 | 133,690 |
| Construction and real estate companies | 127,407 | 106,906 | 4,146 | 15,328 | 3,133 | 5,173 | 2,870 | 117,258 |
| Holding companies | 74,041 | 51,374 | 1,900 | 19,757 | 829 | 2,909 | 2,558 | 68,755 |
| Retail | 45,831 | 36,184 | 1,354 | 7,170 | 3,115 | 2,478 | 1,752 | 39,611 |
| Services | 47,847 | 36,463 | 1,295 | 9,034 | 2,161 | 2,350 | 1,553 | 42,838 |
| Information, technology and communication | 19,862 | 14,311 | 338 | 5,455 | 107 | 97 | 71 | 19,347 |
| Manufacturing | 26,476 | 23,077 | 502 | 3,058 | 763 | 342 | 173 | 25,038 |
| Agriculture | 12,666 | 4,951 | 139 | 7,215 | 271 | 501 | 428 | 11,827 |
| Other | 3,411 | 3,403 | 166 | - | - | 7 | 6 | 3,238 |
| **Total** | **789,142** | **609,122** | **15,084** | **151,893** | **20,764** | **28,130** | **17,215** | **736,081** |

| At 31 December 2012 | Gross carrying amount | Gross not individually impaired | Collective allowance | Individually impaired – Of which performing – Gross carrying amount | Individually impaired – Of which performing – Individual allowance | Individually impaired – Of which non-performing* – Gross carrying amount | Individually impaired – Of which non-performing* – Individual allowance | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Financial institutions | 64,349 | 64,349 | - | - | - | - | - | 64,349 |
| Public entities | 11,682 | 7,794 | 44 | 3,768 | 51 | 120 | 11 | 11,576 |
| Individuals | 207,608 | 167,667 | 2,632 | 25,984 | 3,549 | 13,956 | 6,379 | 195,047 |
| Corporations | | | | | | | | |
| Fisheries | 149,477 | 89,405 | 2,582 | 56,827 | 2,448 | 3,245 | 1,496 | 142,952 |
| Construction and real estate companies | 112,558 | 82,272 | 3,835 | 24,914 | 1,926 | 5,371 | 1,869 | 104,928 |
| Holding companies | 66,235 | 40,464 | 3,087 | 22,614 | 564 | 3,157 | 2,575 | 60,009 |
| Retail | 47,549 | 33,737 | 1,520 | 11,139 | 2,376 | 2,673 | 1,634 | 42,019 |
| Services | 55,917 | 45,944 | 986 | 8,036 | 1,323 | 1,937 | 908 | 52,700 |
| ITC | 19,770 | 14,202 | 126 | 5,473 | 186 | 95 | 46 | 19,413 |
| Manufacturing | 26,802 | 22,807 | 346 | 3,347 | 458 | 649 | 334 | 25,665 |
| Agriculture | 10,747 | 5,098 | 248 | 5,219 | 127 | 429 | 173 | 10,199 |
| Other | 1,772 | 1,573 | 102 | - | - | 201 | 90 | 1,581 |
| **Total** | **774,466** | **575,312** | **15,508** | **167,321** | **13,008** | **31,833** | **15,515** | **730,438** |

*Non-performing past due more than 90 days

All amounts are in ISK million

### 34. Allowance for impairment on loans and advances to customers and other financial assets

| | 1.1-30.6.2013 | | | 1.1-30.6.2012 | | |
|---|---|---|---|---|---|---|
| | Customers | Other financial assets | Total | Customers | Other financial assets | Total |
| Balance at the beginning of the year | 44,030 | - | 44,030 | 28,420 | - | 28,420 |
| Impairment loss for the period | 8,963 | - | 8,963 | 9,919 | - | 9,919 |
| Collected previously written-off loans | 3,530 | - | 3,530 | 551 | - | 551 |
| Loans written-off | (3,460) | - | (3,460) | (1,161) | - | (1,161) |
| **Balance at the end of the period** | **53,063** | **0** | **53,063** | **37,729** | **0** | **37,729** |
| | | | | | | |
| Individual allowance | 37,979 | - | 37,979 | 23,275 | - | 23,275 |
| Collective allowance | 15,084 | - | 15,084 | 14,454 | - | 14,454 |
| **Total** | **53,063** | **0** | **53,063** | **37,729** | **0** | **37,729** |
| | | | | | | |
| **Net impairment loss** | | | | | | |
| Impairment loss for the period | 8,963 | - | 8,963 | 9,919 | - | 9,919 |
| Impairment of claims reversed | - | (269) | (269) | - | (3,480) | (3,480) |
| **Net impairment loss for the period** | **8,963** | **(269)** | **8,694** | **9,919** | **(3,480)** | **6,439** |

### 35. Large exposures

At 30 June 2013, two Group clients were rated as large exposures (31 December 2012: two clients). 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 30 June 2013 and 31 December 2012.

At 30 June 2013, no exposure exceeded 20% (31 December 2012: no 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 30 June 2013** | Number of large exposures | Large exposures |
|---|---|---|
| Large exposures between 10% and 20% of the Group's capital base | 2 | 67,095 |
| **Total** | **2** | **67,095** |
| | | |
| Utilisation ratio (400% max limit) | | 29% |
| | | |
| **At 31 December 2012** | | |
| Large exposures between 10% and 20% of the Group's capital base | 2 | 71,610 |
| **Total** | **2** | **71,610** |
| | | |
| Utilisation ratio (400% max limit) | | 32% |

## Liquidity risk

### 36. Liquidity risk management

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). Another method the Group uses is the cash ratio which shows the ratio of on-demand deposits that the Group could deliver with cash and cash equivalents such as cash at hand, balances with Central Bank and loans to financial institutions (maturity within seven days). The core liquidity ratio as at 30 June 2013 was 45% (31 December 2012: 48%) and the ratio of cash and cash equivalents to on-demand deposits was 15% (31 December 2012: 12%). Aggregated values for the core liquidity ratio are based on daily values and aggregated values for the cash ratio are based on monthly values.

All amounts are in ISK million

### 36. Liquidity risk management (continued)

The following table shows various values of the core liquidity ratio and cash ratio in the period from 1 January to 30 June 2013 and in the year 2012:

| | Core liquidity ratio | | Cash ratio | |
|---|---|---|---|---|
| | 30.6.2013 | 31.12.2012 | 30.6.2013 | 31.12.2012 |
| Period end | 45% | 48% | 15% | 12% |
| Maximum | 52% | 51% | 20% | 32% |
| Minimum | 41% | 36% | 10% | 12% |
| Average | 47% | 45% | 15% | 20% |

### 37. Maturity analysis of financial assets and liabilities

The following table shows a maturity analysis of the Group's financial instruments as at 30 June 2013:

| 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 | 23,643 | - | - | - | - | 23,643 | 23,643 |
| Bonds and debt instruments | - | 57,633 | 43,506 | 57,662 | 197,514 | 356,315 | 278,386 |
| Loans and advances to financial institutions | - | 63,223 | 5,736 | 1,713 | - | 70,672 | 70,671 |
| Loans and advances to customers | 20,606 | 76,726 | 97,369 | 368,330 | 386,876 | 949,907 | 665,411 |
| Other financial assets | - | 9,144 | - | 556 | - | 9,700 | 9,700 |
| **Total** | **44,249** | **206,726** | **146,611** | **428,261** | **584,390** | **1,410,237** | **1,047,811** |
| | | | | | | | |
| **Derivative financial assets** | | | | | | | |
| **Gross settled derivatives** | | | | | | | 96 |
| Inflow | - | 33,588 | 931 | - | - | 34,519 | |
| Outflow | - | (33,496) | (934) | - | - | (34,430) | |
| Total | **0** | **92** | **(3)** | **0** | **0** | **89** | **96** |
| **Net settled derivatives** | - | 28 | - | - | - | 28 | 28 |
| **Total** | **0** | **120** | **(3)** | **0** | **0** | **117** | **124** |
| | | | | | | | |
| **Non-derivative financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (101,356) | (8,670) | - | - | - | (110,026) | (110,025) |
| Deposits from customers | (313,059) | (70,442) | (40,233) | (24,930) | (5,466) | (454,130) | (448,931) |
| Short positions | - | (6,336) | - | - | - | (6,336) | (6,317) |
| Secured bonds | - | (150) | (14,997) | (276,366) | (37,054) | (328,567) | (297,459) |
| Other financial liabilities | - | (13,045) | - | - | - | (13,045) | (13,045) |
| **Total** | **(414,415)** | **(98,643)** | **(55,230)** | **(301,296)** | **(42,520)** | **(912,104)** | **(875,777)** |
| | | | | | | | |
| **Off-balance sheet items** | | | | | | | |
| Financial guarantees and underwriting commitments | (12) | (1,570) | (2,305) | (2,124) | (8,669) | (14,680) | |
| Undrawn loan commitments | (39,844) | - | - | - | - | (39,844) | |
| Undrawn overdraft/credit card commitments | (54,499) | - | - | - | - | (54,499) | |
| **Total** | **(94,355)** | **(1,570)** | **(2,305)** | **(2,124)** | **(8,669)** | **(109,023)** | |
| | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet items** | **(508,770)** | **(100,213)** | **(57,535)** | **(303,420)** | **(51,189)** | **(1,021,127)** | **(875,777)** |
| | | | | | | | |
| **Derivative financial liabilities** | | | | | | | |
| **Gross settled derivatives** | | | | | | | **(663)** |
| Inflow | - | 24,645 | - | 1,098 | - | 25,743 | |
| Outflow | - | (24,692) | - | (1,431) | - | (26,123) | |
| Total | **0** | **(47)** | **0** | **(333)** | **0** | **(380)** | **(663)** |
| **Net settled derivatives** | - | (64) | - | - | - | (64) | (64) |
| **Total** | **0** | **(111)** | **0** | **(333)** | **0** | **(444)** | **(727)** |
| | | | | | | | |
| **Net liquidity position** | **(464,521)** | **106,522** | **89,073** | **124,508** | **533,201** | **388,783** | **171,431** |

All amounts are in ISK million

### 37. 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 2012:

| 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 | 25,898 | - | - | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | - | 52,191 | 12,202 | 48,362 | 158,688 | 271,443 | 228,208 |
| Loans and advances to financial institutions | - | 55,035 | 7,726 | 1,591 | - | 64,352 | 64,349 |
| Loans and advances to customers | 15,169 | 68,164 | 97,531 | 396,142 | 374,154 | 951,160 | 666,087 |
| Other financial assets | - | 10,016 | - | 465 | - | 10,481 | 10,481 |
| **Total** | **41,067** | **185,406** | **117,459** | **446,559** | **532,842** | **1,323,333** | **995,023** |
| | | | | | | | |
| **Derivative financial assets** | | | | | | | |
| **Gross settled derivatives** | | | | | | | 1,040 |
| Inflow | - | 31,169 | - | - | - | 31,169 | |
| Outflow | - | (33,694) | - | - | - | (33,694) | |
| Total | **0** | **(2,525)** | **0** | **0** | **0** | **(2,525)** | **1,040** |
| **Net settled derivatives** | - | 3 | - | - | - | 3 | 3 |
| **Total** | **0** | **(2,522)** | **0** | **0** | **0** | **(2,522)** | **1,043** |
| | | | | | | | |
| **Non-derivative financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (97,646) | (1,054) | (18) | - | - | (98,718) | (98,718) |
| Deposits from customers | (310,088) | (52,739) | (33,049) | (26,362) | (4,137) | (426,375) | (421,058) |
| Short positions | - | (8,918) | - | - | - | (8,918) | (8,918) |
| Secured bonds | - | (1,164) | (3,401) | (184,607) | (60,329) | (249,501) | (221,791) |
| Contingent bond | - | - | - | (90,261) | (23,351) | (113,612) | (87,474) |
| Other financial liabilities | - | (14,369) | - | - | - | (14,369) | (14,369) |
| **Total** | **(407,734)** | **(78,244)** | **(36,468)** | **(301,230)** | **(87,817)** | **(911,493)** | **(852,328)** |
| | | | | | | | |
| **Off-balance sheet items** | | | | | | | |
| Financial guarantees and underwriting commitments | (297) | (19,855) | (3,434) | (2,102) | (4,976) | (30,664) | |
| Undrawn loan commitments | (32,908) | - | - | - | - | (32,908) | |
| Undrawn overdraft/credit card commitments | (55,190) | - | - | - | - | (55,190) | |
| **Total** | **(88,395)** | **(19,855)** | **(3,434)** | **(2,102)** | **(4,976)** | **(118,762)** | |
| | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet items** | **(496,129)** | **(98,099)** | **(39,902)** | **(303,332)** | **(92,793)** | **(1,030,255)** | **(852,328)** |
| | | | | | | | |
| **Derivative financial liabilities** | | | | | | | |
| **Gross settled derivatives** | | | | | | | **(490)** |
| Inflow | - | 26,093 | 276 | 839 | 284 | 27,492 | |
| Outflow | - | (22,650) | (347) | (1,074) | (371) | (24,441) | |
| Total | **0** | **3,443** | **(71)** | **(235)** | **(87)** | **3,051** | **(490)** |
| **Net settled derivatives** | - | (29) | - | - | - | (29) | (29) |
| **Total** | **0** | **3,414** | **(71)** | **(235)** | **(87)** | **3,022** | **(519)** |
| | | | | | | | |
| **Net liquidity position** | **(455,062)** | **88,199** | **77,486** | **142,992** | **439,962** | **293,578** | **143,219** |

for the six months ended 30 June 2013 35 All amounts are in ISK million

### 38. 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 30 June 2013:

| 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 | 3,138 | 143,844 | 67,868 | 166,237 | 12,406 | 393,493 | 366,654 |
| ISK | 41,111 | 62,882 | 78,743 | 262,024 | 571,984 | 1,016,744 | 681,157 |
| **Total** | **44,249** | **206,726** | **146,611** | **428,261** | **584,390** | **1,410,237** | **1,047,811** |
| **Derivative financial assets** | | | | | | | |
| Total in foreign currencies | - | 392 | (3) | - | - | 389 | 96 |
| ISK | - | (272) | - | - | - | (272) | 28 |
| **Total** | **0** | **120** | **(3)** | **0** | **0** | **117** | **124** |
| **Non-derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | (69,141) | (4,129) | (25,187) | (275,055) | (37,054) | (410,566) | (379,625) |
| ISK | (345,274) | (94,514) | (30,043) | (26,241) | (5,466) | (501,538) | (496,152) |
| **Total** | **(414,415)** | **(98,643)** | **(55,230)** | **(301,296)** | **(42,520)** | **(912,104)** | **(875,777)** |
| **Off-balance sheet items** | | | | | | | |
| Total in foreign currencies | (10,085) | (1,274) | (1,098) | (515) | (329) | (13,301) | |
| ISK | (84,270) | (296) | (1,207) | (1,609) | (8,340) | (95,722) | |
| **Total** | **(94,355)** | **(1,570)** | **(2,305)** | **(2,124)** | **(8,669)** | **(109,023)** | |
| **Derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | - | 422 | - | 394 | - | 816 | (663) |
| ISK | - | (533) | - | (727) | - | (1,260) | (64) |
| **Total** | **0** | **(111)** | **0** | **(333)** | **0** | **(444)** | **(727)** |
| **Net liquidity position in foreign currencies** | **(76,088)** | **139,255** | **41,580** | **(108,939)** | **(24,977)** | **(29,169)** | **(13,538)** |
| **Net liquidity position in ISK** | **(388,433)** | **(32,733)** | **47,493** | **233,447** | **558,178** | **417,952** | **184,969** |
| **Net liquidity position** | **(464,521)** | **106,522** | **89,073** | **124,508** | **533,201** | **388,783** | **171,431** |

All amounts are in ISK million

### 38. 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 2012:

| 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 | 2,109 | 122,299 | 45,852 | 172,123 | 24,002 | 366,385 | 335,019 |
| ISK | 38,958 | 63,107 | 71,607 | 274,436 | 508,840 | 956,948 | 660,004 |
| **Total** | **41,067** | **185,406** | **117,459** | **446,559** | **532,842** | **1,323,333** | **995,023** |
| **Derivative financial assets** | | | | | | | |
| Total in foreign currencies | - | (1,964) | - | - | - | (1,964) | 1,040 |
| ISK | - | (558) | - | - | - | (558) | 3 |
| **Total** | **0** | **(2,522)** | **0** | **0** | **0** | **(2,522)** | **1,043** |
| **Non-derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | (62,542) | (5,127) | (6,495) | (274,868) | (83,680) | (432,712) | (378,847) |
| ISK | (345,192) | (73,117) | (29,973) | (26,362) | (4,137) | (478,781) | (473,480) |
| **Total** | **(407,734)** | **(78,244)** | **(36,468)** | **(301,230)** | **(87,817)** | **(911,493)** | **(852,328)** |
| **Off-balance sheet items** | | | | | | | |
| Total in foreign currencies | (13,398) | (644) | (2,509) | (571) | (286) | (17,408) | |
| ISK | (74,997) | (19,211) | (924) | (1,530) | (4,689) | (101,351) | |
| **Total** | **(88,395)** | **(19,855)** | **(3,434)** | **(2,102)** | **(4,976)** | **(118,762)** | |
| **Derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | - | 9,228 | 101 | 302 | 101 | 9,731 | (490) |
| ISK | - | (5,814) | (172) | (537) | (188) | (6,709) | (29) |
| **Total** | **0** | **3,414** | **(71)** | **(235)** | **(87)** | **3,022** | **(519)** |
| **Net liquidity position in foreign currencies** | **(73,831)** | **123,792** | **36,949** | **(103,014)** | **(59,863)** | **(75,968)** | **(43,278)** |
| **Net liquidity position in ISK** | **(381,231)** | **(35,593)** | **40,538** | **246,007** | **499,826** | **369,549** | **186,498** |
| **Net liquidity position** | **(455,062)** | **88,199** | **77,487** | **142,993** | **439,963** | **293,578** | **143,219** |

## Market risk

### 39. Market risk management

The following table summarises the Group's exposure to market risk as at 30 June 2013 and 31 December 2012:

| Market risk factor | 30.6.2013 % of RWA | 31.12.2012 % of RWA |
|---|---|---|
| Equity price risk | 5.9% | 6.3% |
| Interest rate risk | 4.0% | 2.0% |
| Foreign exchange risk | 1.7% | 2.9% |
| **Total** | **11.6%** | **11.2%** |

The currency risk in the Group's trading portfolios is disclosed together with that in its non-trading portfolios in Notes 42-43.

for the six months ended 30 June 2013 37 All amounts are in ISK million

## 40. 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 5). The amounts presented are categorised by the earlier of either the contractual repricing or the maturity date.

| At 30 June 2013 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 23,643 | - | - | - | 23,643 |
| Bonds and debt instruments | 216,782 | 37,232 | 2,992 | 21,380 | 278,386 |
| Derivative instruments | 124 | - | - | - | 124 |
| Loans and advances to financial institutions | 63,222 | 5,736 | 1,713 | - | 70,671 |
| Loans and advances to customers | 459,874 | 63,851 | 74,780 | 66,906 | 665,411 |
| Other financial assets | 9,144 | - | 556 | - | 9,700 |
| **Total** | **772,789** | **106,819** | **80,041** | **88,286** | **1,047,935** |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | (110,025) | - | - | - | (110,025) |
| Deposits from customers | (441,624) | (6,684) | (623) | - | (448,931) |
| Derivative instruments and short positions | (728) | (3,948) | (2,280) | (88) | (7,044) |
| Secured bonds | (296,295) | - | (1,164) | - | (297,459) |
| Contingent bond | - | - | - | - | 0 |
| Other financial liabilities | (13,045) | - | - | - | (13,045) |
| **Total** | **(861,717)** | **(10,632)** | **(4,067)** | **(88)** | **(876,504)** |
| | | | | | |
| Net on-balance sheet position | (88,928) | 96,187 | 75,974 | 88,198 | 171,431 |
| Net off-balance sheet position | 560 | - | (560) | - | |
| | | | | | |
| **Total interest repricing gap** | **(88,368)** | **96,187** | **75,414** | **88,198** | |

| At 31 December 2012 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 25,898 | - | - | - | 25,898 |
| Bonds and debt instruments | 214,996 | 6,395 | 1,331 | 5,486 | 228,208 |
| Derivative instruments | 1,043 | - | - | - | 1,043 |
| Loans and advances to financial institutions | 55,032 | 7,726 | 1,591 | - | 64,349 |
| Loans and advances to customers | 483,493 | 62,515 | 58,198 | 61,881 | 666,087 |
| Other financial assets | 10,017 | - | 464 | - | 10,481 |
| **Total** | **790,479** | **76,636** | **61,584** | **67,367** | **996,066** |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | (98,718) | - | - | - | (98,718) |
| Deposits from customers | (418,750) | (1,861) | (447) | - | (421,058) |
| Derivative instruments and short positions | (521) | (5,257) | (2,717) | (943) | (9,438) |
| Secured bonds | (221,791) | - | - | - | (221,791) |
| Contingent bond | (87,474) | - | - | - | (87,474) |
| Other financial liabilities | (14,369) | - | - | - | (14,369) |
| **Total** | **(841,623)** | **(7,118)** | **(3,164)** | **(943)** | **(852,848)** |
| | | | | | |
| Net on-balance sheet position | (51,144) | 69,518 | 58,420 | 66,424 | 143,218 |
| Net off-balance sheet position | 698 | (133) | (418) | (146) | |
| | | | | | |
| **Total interest repricing gap** | **(50,446)** | **69,385** | **58,002** | **66,278** | |

All amounts are in ISK million

## 41. 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. To mitigate this imbalance, which the Bank is in a limited position to do, the Bank offers non-CPI indexed loans and CPI-indexed deposits.

CPI indexation risk is managed centrally within the Group by the Treasury of the Bank, and is monitored by Market Risk. At 30 June 2013 the CPI imbalance, calculated as the difference between CPI-indexed financial assets and liabilities, was ISK 173,467 million (31 December 2012: ISK 145,784 million).

| **Carrying amount** | **30.6.2013** | **31.12.2012** |
|---|---|---|
| **Assets** | | |
| Bonds and debt instruments | 25,553 | 7,586 |
| Loans and advances to customers | 250,218 | 239,432 |
| **Total** | **275,771** | **247,018** |
| | | |
| **Liabilities** | | |
| Due to financial institutions and Central Bank | (16) | (23) |
| Deposits from customers | (100,992) | (100,768) |
| **Total** | **(101,008)** | **(100,791)** |
| | | |
| Total on-balance sheet position | 174,762 | 146,227 |
| Total off-balance sheet position | (1,295) | (443) |
| | | |
| **Total CPI indexation balance** | **173,467** | **145,784** |

## 42. 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 15% of the Bank's Capital base, in each currency and for all currencies combined. The Bank submits daily and monthly reports to the Central Bank with information on its foreign exchange balance.

The Group's combined net foreign exchange balance as at 30 June was 2.28% of the Group's Capital base (31 December 2012: -9.1%). Uncertainty regarding the denomination currencies of the Groups loan portfolio has not been fully resolved in the period 1 January to 30 June 2013.

## 43. Concentration of currency risk

The following tables summarise the Group's exposure to currency risk at 30 June 2013 and 31 December 2012. The off-balance sheet amounts shown are the notional amounts of the Group's derivative instruments.

Amounts presented under assets and liabilities include all foreign exchange contracts at 30 June 2013 and 31 December 2012. When managing liquidity risk the Group regards foreign exchange contracts as a non-derivative assets or liabilities.

As explained in Note 11 in these Consolidated Financial Statements, the Contingent Bond was issued as Secured Bonds on 11 April 2013, denominated in EUR (50%), USD (30%) and GBP (20%). Using the exchange rate published by the Central Bank of Iceland on 31 December 2012, the Bank converted the final value of the ISK balance of the Contingent Bond into EUR, USD and GBP. The balance of the Secured Bonds was revalued at the exchange rate as at 30 June 2013.

All amounts are in ISK million

## 43. Concentration of currency risk (continued)

| At 30 June 2013 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 640 | 195 | 277 | 11 | 52 | 355 | 1,530 |
| Bonds and debt instruments | 15,471 | 45,157 | 52,779 | - | - | - | 113,407 |
| Equities and equity instruments | 12,314 | 244 | 1 | - | - | 4,907 | 17,466 |
| Derivative instruments | 91 | 4 | 1 | - | - | - | 96 |
| Loans and advances to financial institutions | 33,352 | 9,349 | 14,825 | 2,176 | 71 | 3,037 | 62,810 |
| Loans and advances to customers | 90,369 | 18,086 | 55,902 | 8,404 | 9,307 | 6,728 | 188,796 |
| Other assets | 2 | - | 87 | - | - | 22 | 111 |
| **Total** | **152,239** | **73,035** | **123,872** | **10,591** | **9,430** | **15,049** | **384,216** |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (7,681) | (3,798) | (5,563) | - | (139) | (706) | (17,887) |
| Deposits from customers | (23,078) | (4,780) | (25,305) | (1,709) | (969) | (6,811) | (62,652) |
| Derivative instruments and short positions | (180) | (10) | (473) | - | - | - | (663) |
| Secured bonds | (147,464) | (54,965) | (93,866) | - | - | - | (296,295) |
| Other liabilities | (1,190) | (412) | (631) | (18) | (10) | (520) | (2,781) |
| **Total** | **(179,593)** | **(63,965)** | **(125,838)** | **(1,727)** | **(1,118)** | **(8,037)** | **(380,278)** |
| | | | | | | | |
| Net on-balance sheet position | (27,354) | 9,070 | (1,966) | 8,864 | 8,312 | 7,012 | **3,938** |
| Net off-balance sheet position | 33,891 | (11,794) | 5,677 | (8,135) | (7,612) | (10,821) | **1,206** |
| | | | | | | | |
| **Net currency position** | **6,537** | **(2,724)** | **3,711** | **729** | **700** | **(3,809)** | **5,144** |

| At 31 December 2012 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 400 | 173 | 229 | 13 | 40 | 377 | 1,232 |
| Bonds and debt instruments | 8,995 | 35,200 | 34,483 | - | - | - | 78,678 |
| Equities and equity instruments | 11,381 | - | 1 | - | - | 3,339 | 14,721 |
| Derivative instruments | 1,037 | - | 3 | - | - | - | 1,040 |
| Loans and advances to financial institutions | 32,399 | 1,630 | 9,360 | 3,095 | 2,961 | 4,600 | 54,045 |
| Loans and advances to customers | 90,044 | 19,250 | 58,169 | 12,406 | 12,777 | 6,642 | 199,288 |
| Other assets | 502 | - | 1,761 | 1 | - | 30 | 2,294 |
| Assets classified as held for sale | 288 | - | - | - | - | - | 288 |
| **Total** | **145,046** | **56,253** | **104,006** | **15,515** | **15,778** | **14,988** | **351,586** |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (5,438) | (4,068) | (4,870) | - | (148) | (823) | (15,348) |
| Deposits from customers | (15,814) | (6,007) | (21,671) | (520) | (428) | (6,456) | (50,895) |
| Derivative instruments and short positions | (176) | - | (314) | - | - | - | (491) |
| Secured bonds | (109,380) | (42,397) | (70,013) | - | - | - | (221,791) |
| Contingent bond | (87,474) | - | - | - | - | - | (87,474) |
| Other liabilities | (580) | (70) | (2,197) | (6) | (2) | (536) | (3,391) |
| **Total** | **(218,862)** | **(52,542)** | **(99,065)** | **(526)** | **(578)** | **(7,815)** | **(379,390)** |
| | | | | | | | |
| Net on-balance sheet position | (73,816) | 3,711 | 4,941 | 14,990 | 15,201 | 7,171 | **(27,802)** |
| Net off-balance sheet position | 49,234 | (2,948) | (5,532) | (13,882) | (13,768) | (5,337) | **7,767** |
| | | | | | | | |
| **Net currency position** | **(24,582)** | **763** | **(591)** | **1,108** | **1,433** | **1,834** | **(20,035)** |

All amounts are in ISK million

## 44. Foreign exchange rates used

The following foreign exchange rates were used by the Group:

| | At 30 June 2013 | At 31 December 2012 | % Change | Average for 1.1-30.6 2013 | Average for 1.1-30.6 2012 |
|---|---|---|---|---|---|
| EUR/ISK | 161.25 | 168.95 | (4.6%) | 162.27 | 161.47 |
| GBP/ISK | 188.35 | 207.22 | (9.1%) | 191.39 | 184.97 |
| USD/ISK | 123.95 | 128.16 | (3.3%) | 123.75 | 114.40 |
| JPY/ISK | 1.25 | 1.49 | (16.1%) | 1.31 | 1.40 |
| CHF/ISK | 131.10 | 139.94 | (6.3%) | 132.39 | 127.75 |
| CAD/ISK | 117.88 | 128.73 | (8.4%) | 121.49 | 117.41 |
| DKK/ISK | 21.62 | 22.64 | (4.5%) | 21.76 | 21.66 |
| NOK/ISK | 20.33 | 22.96 | (11.5%) | 21.49 | 20.69 |
| SEK/ISK | 18.41 | 19.68 | (6.5%) | 18.98 | 18.09 |

All amounts are in ISK million

# Consolidated Financial Statements

2012

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# Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. (the "Bank") for the financial year 2012 include the Bank and its subsidiaries (collectively referred to as the "Group").

Landsbankinn was founded on 7 October 2008. The Group offers a complete range of financial products and services for personal, corporate and institutional customers.

Landsbankinn is currently owned by the Icelandic State Treasury, which wields 81.3% of voting rights, and Landskil ehf., which is owned by LBI hf. (formerly Landsbanki Íslands hf.) and wields 18.7% of voting rights.

## Operations in 2012

Consolidated profit amounted to ISK 25,494 million for the financial year 2012. The Board of Directors proposes that up to 40% of the consolidated profit will, subject to an approval at a shareholder´s meeting, be paid in dividends to shareholders. Otherwise the profit will be added to the Bank's equity. Consolidated total equity amounted to ISK 225,166 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 25.1% at year-end 2012. The number of full-time equivalent positions was 1.233 at year-end 2012.

In the first and second quarters of 2012, the Bank made an early redemption payment and a partial pre-payment of the Secured Bonds in the amount of ISK 72,115 million. These Bonds were issued in 2010 as a part of the acquisition price for the acquired assets and liabilities assumed from LBI hf. The Bank's strong liquidity position in foreign currencies enabled the Bank to reduce its long-term liabilities faster than contractual provisions require.

Shares in the facilities management company Reginn hf. were listed on the NASDAQ OMX Iceland, following a public offering in June 2012. 75% of the Group's shares in Reginn were sold in the public offering and the acquirers became shareholders of Reginn on 29 June 2012. The Group has committed itself to hold the remaining 25% of the shares in Reginn hf. for a minimum of 10 months from 29 June 2012.

The arbitration panel set up to resolve the dispute between the Bank and the National Treasury regarding the fair value of the financial assets of SpKef, presented its conclusions on 7 June 2012. It was concluded that the fair value, payable by the National Treasury to the Bank, was ISK 19,198 million. Following the Bank's review of the fair value of these financial assets a net loss of ISK 2.889 million was accounted for in the Group's financial statements in the second quarter of 2012.

On 15 February 2012 and 18 October 2012, the Supreme Court of Iceland ruled in two separate cases that a lender could not apply the Central Bank interest rates under circumstances specified in the rulings, inter alia, as the lender had issued final receipt of payment of interests. The Group has accounted for the potential impact of the these rulings and recognised expenses in the amount of ISK 38,042 million and ISK 2,120 million in its consolidated income statement at year end 2011 and 2012, respectively. Further court rulings are awaited to obtain final clarification of the precedence of these rulings. The total amount of the estimated impact may change accordingly. The Bank expects that a part of these expenses will be reversed once the application of the Court's precedent has been fully clarified.

In two separate litigations commenced against the Bank during the year 2012, currency indexation of loans is being disputed. It is the position of the Bank that circumstances in these cases differ from that of the circumstances in previous litigations involving currency indexation of loans, which the Supreme Court has ruled illegal, and that the loans now under litigation shall be regarded as loans in foreign currencies. Further description of the circumstances and the status of these legal proceedings is provided in Notes 4 and 37.

On 11 September 2012, Landsbréf hf., a subsidiary of the Bank, obtained a licence from the Financial Supervisory Authority to undertake asset management. The licence provides Landsbréf with the opportunity to manage projects in the field of asset management for third parties and thus expands greatly the company's opportunities to service its customers.

As at 31 December 2012, the Bank's fair value estimate of the Contingent Bond liability was ISK 87,474 million. This corresponds to a nominal amount of ISK 88,142 million, which is lower than the Bond's nominal amount ceiling of ISK 92,000 million. The estimate is that of the management of the Bank, but the final and binding amount of the Bond is still being determined by a third-party valuation agent, whose conclusions are expected to be presented no later than 31 March 2013. The Bank will issue the Bond to LBI hf. no later than 31 March 2013, based on the valuation agent's final amount, converted into EUR at the exchange rate as of 31 December 2012.

## Outlook

Landsbankinn estimates that economic growth in Iceland will continue in 2013 and be 2.4%. Growth will be mostly driven by growth of capital formation and private consumption.

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

Horn fjárfestingarfélag hf. is a subsidiary of the Bank with holdings in listed and unlisted equities in a wide variety of industrial sectors. These assets will be offered for sale in 2013.

The Bank's core operations are sound and have been improving continuously. Foundations have been laid with new and revised processes 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 2012, 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 43-85.

## Other issues

At the end of third quarter of 2012, Landsbankinn concluded its strategic review and set out commitments for 2015. The strategy entails a stronger focus on operational efficiency by reducing cost, strengthening management and team unity, while also pursuing responsible and profitable market initiatives. At the same time, the Bank made significant changes to its organisational structure which became effective as of 1 October 2012.

As explained in the Endorsement by the Board of Directors of the Bank's condensed consolidated interim financial statements for the first nine months of 2012 and in the Bank's Annual Report of 2011, it is of great concern to the Board of Directors that the Bank, a public limited liability company operating in a competitive environment, is unable to determine the salary of the CEO of the Bank. The CEO salary and employment conditions are determined by the Civil Servants Salary Board (Kjararáð). The Salary Board has considered itself not to be authorised to set the CEO salary for "daytime work" higher than the nominal salary of the Prime Minister. When introduced, it was the understanding of the Board of Directors that this would be a temporary arrangement to be abolished at the end of 2010. The arrangement, however, continues to be in place. It is concluded in opinions prepared by legal advisors of the Board of Directors that the current arrangement is contrary to the Constitution of Iceland and the Agreement on the European Economic Area.

The Board of Directors has submitted a letter to the Civil Servants Salary Board formally requesting that the Salary Board determine, by way of a new decision, acceptable salary and employment conditions for the CEO. The Salary Board is still considering the matter. The Board of Directors has, moreover, collected data and documentation on salaries for comparable professions during 2011 and 2012 that will presumably serve as a basis for an eventual final decision on the CEO salary and employment conditions for the same period.

Having regard to the above, the Board of Directors considers that it is prudent to make a provision in the amount of ISK 47 million due to possible corrections or retroactive adjustments of the CEO salary and employment conditions for the years 2011 and 2012 that may be considered necessary, inter alia, due to an eventual revision of the Salary Board's decision or on the premise that the relevant provisions of the Act No 47/2006 on the Civil Servants Salary Board, cf. Act No 87/2009, do not comply with the Constitution of Iceland or with the Agreement on the European Economic Area.

## Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. for the year ended 31 December 2012 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 2012, its consolidated financial position as at 31 December 2012 and its consolidated cash flows for the year 2012.

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 2012 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, 7 March 2013.

Board of Directors

Gunnar Helgi Hálfdanarson

Chairman

Þórdís Ingadóttir

Sigríður Hrólfsdóttir

Jón Sigurðsson

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. and its subsidiaries, which comprise the consolidated statement of financial position as at 31 December, 2012, 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 31 December, 2012, 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, 7 March 2013.

*KPMG ehf.*

Helgi F. Arnarson

Sigríður Helga Sveinsdóttir

# Consolidated Statement of Financial Position as at 31 December 2012

| Notes | | 2012 | 2011 |
|---|---|---|---|
| | **Assets** | | |
| 8 | Cash and balances with Central Bank | 25,898 | 8,823 |
| 7,9,38 | Bonds and debt instruments | 228,208 | 221,848 |
| 7,9 | Equities and equity instruments | 36,881 | 46,037 |
| 7,10 | Derivative instruments | 1,043 | 159 |
| 11 | Loans and advances to financial institutions | 64,349 | 100,133 |
| 12,38 | Loans and advances to customers | 666,087 | 639,130 |
| 13 | Investments in equity-accounted associates | 15,528 | 11,678 |
| 14 | Property and equipment | 6,776 | 6,437 |
| 15 | Intangible assets | 541 | 681 |
| 22 | Deferred tax assets | 48 | 3,003 |
| 16 | Other assets | 14,108 | 44,001 |
| | | **1,059,467** | **1,081,930** |
| 17 | Assets classified as held for sale | 25,320 | 53,552 |
| | **Total assets** | **1,084,787** | **1,135,482** |
| | **Liabilities** | | |
| 18 | Due to financial institutions and Central Bank | 98,718 | 112,876 |
| 19 | Deposits from customers | 421,058 | 443,590 |
| 10 | Derivative instruments and short positions | 9,438 | 7,916 |
| 22 | Tax liabilities | 0 | 70 |
| 20,38 | Secured bonds | 221,791 | 277,076 |
| 7,21,38 | Contingent bond | 87,474 | 60,826 |
| 23 | Other liabilities | 20,249 | 23,499 |
| | | **858,728** | **925,853** |
| | Liabilities associated with assets classified as held for sale | 893 | 9,385 |
| | **Total liabilities** | **859,621** | **935,238** |
| 24 | **Equity** | | |
| | Share capital | 24,000 | 24,000 |
| | Share premium | 123,898 | 123,898 |
| | Statutory reserve | 5,053 | 3,781 |
| | Retained earnings | 72,120 | 47,952 |
| | **Total equity attributable to owners of the Bank** | **225,071** | **199,631** |
| | Non-controlling interests | 95 | 613 |
| | **Total equity** | **225,166** | **200,244** |
| | **Total liabilities and equity** | **1,084,787** | **1,135,482** |

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

Landsbankinn hf. Consolidated Financial Statements 2012 5 All amounts are in ISK million

## Consolidated Income Statement for the Year ended 31 December 2012

| Notes | | 2012 | 2011 |
|---|---|---|---|
| | Interest income | 64,661 | 60,831 |
| | Interest expense | (29,077) | (28,182) |
| 25 | **Net interest income** | **35,584** | **32,649** |
| 26 | Net adjustments to loans and advances acquired at deep discount | 37,320 | 58,489 |
| 4, 26 | Loss from foreign currency linkage of loans and advances to customers | (2,120) | (40,726) |
| 26, 65 | Net impairment loss | (12,260) | (7,034) |
| 7,21 | Fair value change of contingent bond | (27,331) | (34,316) |
| | **Net adjustments in valuation** | **(4,391)** | **(23,587)** |
| | **Net interest income after net adjustments in valuation** | **31,193** | **9,062** |
| | Fee and commission income | 7,696 | 7,437 |
| | Fee and commission expense | (3,248) | (3,014) |
| 27 | **Net fee and commission income** | **4,448** | **4,423** |
| 28,30 | Net gain on financial assets designated as at fair value through profit or loss | 5,703 | 17,459 |
| 29,30 | Net gain on financial assets and liabilities held for trading | 2,169 | 1,009 |
| 31 | Net foreign exchange gain (loss) | 4,566 | (759) |
| 32 | Other income and (expenses) | 1,062 | (450) |
| | **Other net operating income** | **13,500** | **17,259** |
| | **Total operating income** | **49,141** | **30,744** |
| 33 | Salaries and related expenses | 13,176 | 11,990 |
| 34 | Other operating expenses | 8,878 | 8,467 |
| 14 | Depreciation and amortisation | 719 | 771 |
| 23 | Contribution to the Depositors' and Investors' Guarantee Fund | 1,042 | 583 |
| 35 | Acquisition-related costs | 290 | 245 |
| | **Total operating expenses** | **24,105** | **22,056** |
| 13 | Share of profit of equity-accounted associates, net of income tax | 2,449 | 1,417 |
| | **Profit before tax** | **27,485** | **10,105** |
| 36 | Income tax | (2,925) | 1,411 |
| 36 | Tax on liabilities of financial institutions | (1,200) | (814) |
| | **Profit for the year from continuing operations** | **23,360** | **10,702** |
| | Profit for the year from discontinued operations, net of income tax | 2,134 | 6,255 |
| | **Profit for the year** | **25,494** | **16,957** |
| | **Profit for the year attributable to:** | | |
| | **Owners of the Bank** | | |
| | Profit for the year from continuing operations | 23,360 | 10,702 |
| | Profit for the year from discontinued operations | 2,079 | 6,271 |
| | **Profit for the year attributable to owners of the Bank** | **25,439** | **16,973** |
| | **Non-controlling interests** | | |
| | Profit (loss) for the year from discontinued operations | 55 | (16) |
| | **Profit (loss) for the year attributable to non-controlling interests** | **55** | **(16)** |
| | **Profit for the year** | **25,494** | **16,957** |

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

Landsbankinn hf. Consolidated Financial Statements 2012 6 All amounts are in ISK million

# Consolidated Statement of Changes in Equity for the Year ended 31 December 2012

Notes

| Notes | Change in equity for the year 2012 | Share capital | Share premium | Statutory reserve | Retained earnings | Total | Non-controlling interests | Total |
|---|---|---|---|---|---|---|---|---|
| | | Attributable to owners of the Bank | | | | | | |
| | Balance at 1 January 2012 | 24,000 | 123,898 | 3,781 | 47,952 | 199,631 | 613 | 200,244 |
| | Profit for the year | | | | 25,439 | 25,439 | 55 | 25,494 |
| | Transfer to statutory reserve | | | 1,272 | (1,272) | 0 | | 0 |
| | Decrease in non-controlling interest due to acquisition of subsidiary | | | | | | (573) | (573) |
| 24 | **Balance at 31 December 2012** | **24,000** | **123,898** | **5,053** | **72,120** | **225,071** | **95** | **225,166** |
| | **Change in equity for the year 2011** | | | | | | | |
| | 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 | | | | | | 130 | 130 |
| | Decrease in non-controlling interests due to sale of subsidiaries | | | | | | (1,709) | (1,709) |
| 24 | **Balance at 31 December 2011** | **24,000** | **123,898** | **3,781** | **47,952** | **199,631** | **613** | **200,244** |

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 2012

| Notes | | 2012 | 2011 |
|---|---|---|---|
| | **Operating activities** | | |
| | Profit for the year | 25,494 | 16,957 |
| | Adjustments for non-cash items included in profit for the year | (43,778) | (32,349) |
| | Changes in operating assets and liabilities | 77,065 | (50,887) |
| | Interest received | 48,726 | 58,630 |
| | Interest paid | (25,386) | (24,650) |
| 30 | Dividends received | 551 | 598 |
| | Income tax paid | (895) | (1,254) |
| | **Net cash from (used in) operating activities** | **81,777** | **(32,955)** |
| | **Investing activities** | | |
| | Cash and cash equivalents included in net assets acquired | (3) | 1,969 |
| | Acquisition of additional shares in equity-accounted associates | (1,334) | (6,773) |
| | Sale of shares in associates | 2,598 | - |
| 14 | Purchase of property and equipment | (849) | (377) |
| 14 | Proceeds from sale of property and equipment | 71 | 12 |
| 15 | Purchase of intangible assets | (126) | (76) |
| | Sale of financial investments | 9,458 | - |
| | **Net cash from (used in) investing activities** | **9,815** | **(5,245)** |
| | **Financing activities** | | |
| | Repayment of secured bonds | (72,115) | - |
| | Aquisition of non-controlling interest | (472) | - |
| | **Net cash used in financing activities** | **(72,587)** | **0** |
| | Net change in cash and cash equivalents | 19,005 | (38,200) |
| | Cash and cash equivalents at the beginning of the year | 13,625 | 52,654 |
| | Effect of exchange rate changes on cash and cash equivalents held | (144) | (829) |
| | **Cash and cash equivalents at the end of the year** | **32,486** | **13,625** |

| Notes | | 2012 | 2011 |
|---|---|---|---|
| | **Investing and financing activities not affecting cash flows** | | |
| | Assets acquired and liabilities assumed from SpKef Savings Bank | - | (30,480) |
| | Non-controlling interests | - | (116) |
| 5 | Provisional amount of the bond to be issued by the Icelandic State Treasury | (19,198) | 30,596 |
| 5 | Bonds and debt instruments | 19,198 | - |
| | Assets acquired and liabilities assumed from Avant hf. | - | 9,722 |
| | 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.

Landsbankinn hf. Consolidated Financial Statements 2012 8 All amounts are in ISK million

# Consolidated Statement of Cash Flows for the Year ended 31 December 2012

| Notes | | 2012 | 2011 |
|---|---|---|---|
| | **Adjustments for non-cash items included in profit for the year** | | |
| 25 | Net interest income | (35,584) | (32,649) |
| 26 | Net adjustments to loans and advances acquired at deep discount | (37,320) | (58,489) |
| 4, 26 | Loss from foreign currency linkage of loans and advances to customers | 2,120 | 40,726 |
| 26, 65 | Net impairment loss | 12,260 | 7,034 |
| 7,21 | Fair value change of contingent bond | 27,331 | 34,316 |
| 28 | Net (gain) on financial assets designated as at fair value through profit or loss | (5,703) | (17,459) |
| 29 | Net (gain) on financial assets and liabilities held for trading | (2,169) | (1,009) |
| | Net gain on assets classified as held for sale | (2,134) | (6,255) |
| 31 | Net foreign exchange (gain) loss | (4,422) | 1,588 |
| 32 | (Gain) loss on sale of property and equipment | (14) | 61 |
| 32 | (Gain) loss on repossessed collateral | (537) | 1,030 |
| 14 | Depreciation and amortisation | 719 | 771 |
| 13 | Share of profit of equity-accounted associates, net of income tax | (2,449) | (1,417) |
| 36 | Income tax | 2,925 | (1,411) |
| 36 | Tax on liabilities of financial institutions | 1,200 | 814 |
| | | **(43,778)** | **(32,349)** |
| | **Changes in operating assets and liabilities** | | |
| | Change in reserve requirement with Central Bank | 448 | (452) |
| | Change in bonds and equities | 35,545 | (44,088) |
| | Change in loans and advances to financial institutions | 39,838 | (12,633) |
| | Change in loans and advances to customers | 44,598 | 18,812 |
| | Change in investments in associates | (349) | 21,839 |
| | Change in other assets | 5,069 | 2,739 |
| | Change in assets classified as held for sale | (5,937) | (16,831) |
| | Change in due to financial institutions and Central Bank | (15,530) | (55,082) |
| | Change in deposits from customers | (26,401) | 18,095 |
| | Change in repossessed collateral | (1,400) | 1,144 |
| | Change in other liabilities | (2,027) | 2,362 |
| | Change in liabilities associated with assets classified as held for sale | 3,212 | 13,208 |
| | | **77,065** | **(50,887)** |
| | **Cash and cash equivalents is specified as follows:** | | |
| 8 | Cash and unrestricted balances with Central Bank | 23,927 | 6,404 |
| 11 | Bank accounts with financial institutions | 8,559 | 7,221 |
| | **Cash and cash equivalents at the end of the year** | **32,486** | **13,625** |

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

Landsbankinn hf. Consolidated Financial Statements 2012 9 All amounts are in ISK million

# Notes to the Consolidated Financial Statements

# Notes to the Consolidated Financial Statements

## 1. Reporting entity

Landsbankinn 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, thereby taking over part of the domestic operations of LBI hf. (formerly Landsbanki Íslands hf.).

The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank operates in accordance with Act No. 161/2002 on Financial Undertakings and is licensed by the Financial Supervisory Authority in Iceland (FME) as a commercial bank. The Bank is subject to supervision of the FME in accordance with Act No. 87/1998 on Official Supervision of Financial Activities. 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 2012 include the Bank and its subsidiaries (collectively 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 other related services. The Group operates solely in Iceland.

The issue of these consolidated financial statements was authorised by the Board of Directors and the CEO of the Bank on 7 March 2013.

## 2. Basis of preparation

### Statement of compliance

The Consolidated Financial Statements for the year ended 31 December 2012 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 the following:
- Financial assets and liabilities classified as held for trading are measured at fair value;
- Financial assets and liabilities designated as at fair value through profit or loss are measured at fair value;
- Non-current assets and disposal groups classified as held for sale are measured at the lower of cost 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 year.

## 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 by the Group in the consolidated financial statements are the same as those applied by the Group in its consolidated financial statements as at and for the year ended 31 December 2011.

The principal accounting polices used in preparing these consolidated financial statement are set out below.

### 3.1 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.

Intercompany 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.

### 3.2 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”.

*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.

## 3. Significant accounting policies (continued)

### 3.2 Associates (continued)

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 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.

### 3.3 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.

### 3.4 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.

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.

### 3. Significant accounting policies (continued)

**Financial assets and liabilities (continued)**

**(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.

3.4 **(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 instalments 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.

## 3. Significant accounting policies (continued)

### Financial assets and liabilities (continued)

### 3.4 (g) Impairment of financial assets (continued)

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".

*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.

### 3.5 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.

### 3.6 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.

## 3. Significant accounting policies (continued)

### 3.7 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.

### 3.8 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".

*Loans and advances acquired at deep discount*

The Bank acquired loans and advances from LBI 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”.

### 3.9 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.

### 3.10 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.

### 3.11 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.

### 3.12 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.

### 3.13 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.

### 3. Significant accounting policies (continued)

#### 3.14 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.

#### 3.15 Contingent bond

The contingent bond is a contingent obligation of the Bank to issue a bond to LBI hf. no later than 31 March 2013 as an additional consideration for the assets and liabilities transferred from LBI 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.

#### 3.16 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".

#### 3.17 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 primarily bank guarantees and documentary letters of credit. Fees of long term guarantees are claimed up-front periodically over the life of each guarantee, initially at the inception of a guarantee. Fees of short term guarantees are in essence claimed up-front at inception. Fee income arising from the guarantees is recognised over time as the fees become payable. Provisions for losses on guarantees are subject to the uncertainty of assessing the extent to which guarantees may be called upon. For this purpose outstanding bank guarantees and documentary letters of credit are assessed quarterly in respect of credit losses and recognition of provisions. The provision assessment is based on experience with similar transactions and the history of past losses, supplemented by management judgement.

## 3. Significant accounting policies (continued)

### 3.18 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 IFRS's.

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.

### 3.19 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.

### 3.20 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.

### 3.21 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.

### 3.22 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.

### 3.23 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.

### 3.24 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.

### 3. Significant accounting policies (continued)

### 3.25 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.

### 3.26 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.

### 3.27 Net foreign exchange gain (loss)

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.

### 3.28 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.

### 3.29 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.

### 3.30 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.

### 3.31 Segment reporting

An operating segment is a component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components, whose operating results are reviewed regularly by the Group Management Committee (being the chief operating decision maker) to make decisions about resources allocated to each segment and assess its performance, and for which discrete financial information is available.

## 3. Significant accounting policies (continued)

### 3.32 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 2012, and have not been applied in preparing these consolidated financial statements. The new standards and amendments to standards which might have a material effect on the consolidated financial statements of the Group are the following:

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. The amendments to IAS 32 will become mandatory for the Group starting with its consolidated financial statements for the year 2014. The amendments to IFRS 7 will become mandatory for the Group starting with its consolidated financial statements for the year 2013. Restrospective application is required for both amendments to IAS 32 and IFRS 7. The Group does not plan to early adopt IAS 32 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. IFRS 10 will become mandatory for the Group starting with its consolidated financial statements for the year 2014, with retrospective application but subject to specific transition rules. The Group does not plan to early adopt IFRS 10 and it is currently in the process of evaluationg the possible impact of IFRS 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. IFRS 12 will become mandatory for the Group starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transition rules. 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.

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 IFRS's. In general, the disclosures required by IFRS 13 are more extensive than the disclosures required by currently effective standards. 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. The application of IFRS 13 will result in the Group having to provide more extensive disclosures about fair value measurements.

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

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 LBI 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.

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

### (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.

### (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 LBI 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 loan agreements

In 2010, 2011 and 2012 the Supreme Court of Iceland delivered rulings on the illegality of provisions of currency-indexation in loan agreements denominated in Icelandic krona. Under law, such loans are to bear the lowest interest rates of un-indexed loans denominated in Icelandic krona as published by the Central Bank of Iceland.

The Group has accounted for the impact of the these rulings and recognised expenses in the amount of ISK 18,157 million in its consolidated income statement at year end 2010 and an additional ISK 2,684 million in its consolidated income statement at year end 2011. These expenses were recorded in the income statements under line item "Loss from foreign currency linkage of loans and advances to customers".

On 15 February 2012 and 18 October 2012 the Supreme Court ruled in two separate cases that a lender could not apply the Central Bank interest rates under circumstances specified in the rulings, inter alia, as the lender had issued final receipt of payment of interests. The Group has accounted for the potential impact of the these two rulings and recognised, respectively, expenses in the amount of ISK 38,042 million and ISK 2,120 million in its consolidated income statement at year end 2011 and at the end of the third quarter of 2012. These expenses are recorded in the income statements under line item "Loss from foreign currency linkage of loans and advances to customers". Further Court rulings are awaited to obtain final clarification of the precedence of these rulings. The total amount of the estimated impact may change accordingly. The Bank expects that part of these expenses will be reversed once the application of the Court's precedent has been fully clarified.

The litigation section in Note 37 includes two cases commenced against the Bank during the year 2012 where currency indexation of loans is being disputed. It is the position of the Bank that circumstances in these cases are different compared to previous litigations involving currency indexation of loans which the Supreme Court has ruled illegal and that the loans now under litigation shall be regarded as loans in foreign currencies. However, if Court rulings prove unfavourable for the Bank these cases may set precedence for identical loans and have a potential significant impact. The Bank may thus have to recognise expenses in the amount of ISK 28,146 million in the forthcoming periods.

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

### (i) Contingent bond

As at 31 December 2012 the Bank's estimate of the nominal amount of the contingent bond was ISK 88,142 million, which is lower than the bond´s nominal ceiling amount of ISK 92,000 million. The estimate is that of the management of the Bank but the final and binding amount of the bond is still being determined by an independent third-party valuation agent, whose conclusions are expected to be presented no later than 31 March 2013. Any possible difference between the estimate of the management of the Bank and the valuation agent will be recognised in the Bank's 2013 first quarter financial statements. The difference will be recorded in the Group's income statement under line items "Fair value change of contingent bond". Given the nominal ceiling amount of ISK 92,000 million, the increase in the Group's total liabilities due to this is capped at ISK 3,858 million (using the EUR/ISK exchange rate at 31 December 2012). Whatever the final valuation difference will be, it is likely to be counter-balanced by improved recoverability of the Group's loans, such that the impact on the Group's 2013 performance will not be significant. However, any such changes in the underlying assets and the contingent bond may not necessarily be accounted for in the same quarterly financial statements.

## 5. Business combination

### Acquisition of SpKef Savings Bank

On 7 March 2011, the Bank took over all assets, liabilities and operations of SpKef Savings Bank (SpKef) in accordance with the decision of the Financial Supervisory Authority in Iceland (FME). SpKef was owned entirely and directly by the National Treasury previous to the transfer. The National Treasury 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 Bank and the National Treasury did not reach an agreement on the fair value of financial assets of SpKef and as a result the disagreement was referred to an arbitration panel.

In the arbitration panel's conclusion of 7 June 2012 the fair value of the consideration transferred was determined ISK 19,198 million. This is considerably lower than the Bank's original valuation of ISK 30,596 million, which was based on the Bank's view of the fair value of financial assets of SpKef at the acquisition date. This conclusion is final and binding for both parties and resolves the disagreement on the fair value of the consideration transferred. The National Treasury expanded the Treasury bond series RIKH 18, maturing 9 October 2018, by ISK 19,198 million for the purpose of settling the claim of the Bank on the Treasury. As at 30 June 2012 accrued interest on the Treasury bonds since the acquisition date amounted to ISK 890 million. The Bank's review of the fair value of the financial assets of SpKef, following the conclusion of the arbitration panel, confirmed enhanced recovery rates and improved quality of some of the financial assets. As a result, a net loss of ISK 2,889 million (comprising of a loss of ISK 3,779 million from the financial assets less accrued interest of ISK 890 million on the bonds received) was accounted for in the financial statements in the second quarter of 2012.

## 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 four main business segments at the end of the reporting period:

• **Personal Banking** provides financial services through the Bank's branch network to individuals and to small and medium-size businesses,
• **Corporate Banking** provides financial services to large and medium-size corporate clients. Provides restructuring solutions to corporate clients who have defaulted on their loans and can be returned to viability.
• **Markets** provide brokerage services in securities, foreign currencies and derivatives, sale of securities issues, money market lending and advisory services. Markets provides a range of wealth and asset management products and services for individuals, corporations and institutional investors. Horn fjárfestingarfélag and Landsbréf, a subsidiary of the Bank, are included in markets.
• **Treasury** incorporates unallocated capital, funding, liquidity and interbank functions for the Bank as well as management of the Group's market risk.

Other segments comprise of the support functions of Finance, Risk Management, Corporate Development & HR and Operations & IT.

Reconciliation consists of eliminations and transactions that cannot be allocated to any one segment.

Administrative expenses of Group support functions are allocated to appropriate business segments based on the underlying cost drivers.
Expenses are allocated to the business units at market price level. Other segments supplies services to business units, and transactions are settled at unit prices or on an arm's-length basis; if possible, on the basis of consumption and activity.

The following table summarises 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 periods from 1 January to 31 December 2012 and 2011.

On 28 September 2012 the CEO of the Bank presented a new organisational chart for the Group which became formally effective as of 1 October 2012. As a result the Group changed the composition of reportable segments accordingly. The new segment composition and comparative information are reported for the first time in the year end 2012 financial statements of the Group.

In the year 2011 the Group reported seven main business segments: Retail Banking, Vehicle and Equipment Financing, Corporate Banking, Asset Restructuring, Markets & Treasury, Asset Management and the subsidiary Horn fjárfestingarfélag hf.

### 6. Operating segments (continued)

| 1 January - 31 December 2012 | Personal Banking | Corporate Banking | Markets | Treasury | All Other Segments | Total Segments | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 17,396 | 17,739 | 194 | 1,728 | (835) | **36,222** | (637) | **35,584** |
| Net adjustments in valuation | (10,082) | 1,743 | - | 269 | 3,679 | **(4,391)** | - | **(4,391)** |
| Net fee and commission income | 2,382 | 403 | 2,035 | 247 | (237) | **4,830** | (381) | **4,448** |
| Net gain on financial assets designated as at fair value through profit or loss | - | (2) | 3,450 | 2,255 | - | **5,703** | - | **5,703** |
| Net gain on financial assets and liabilities held for trading | - | - | 330 | 1,839 | - | **2,169** | - | **2,169** |
| Net foreign exchange gain (loss) | - | - | 881 | 3,685 | - | **4,566** | - | **4,566** |
| Other income and (expenses) | (149) | (22) | 62 | 472 | 408 | **771** | 291 | **1,062** |
| **Total operating income (expense)** | **9,547** | **19,861** | **6,952** | **10,495** | **3,015** | **49,870** | **(727)** | **49,141** |
| Total operating expenses | (13,437) | (3,704) | (2,394) | (2,677) | (2,228) | **(24,440)** | 335 | **(24,105)** |
| Share of profit of equity-accounted associates, net of income tax | 618 | - | - | 1,793 | 38 | **2,449** | - | **2,449** |
| **Profit (loss) before tax** | **(3,272)** | **16,157** | **4,558** | **9,611** | **825** | **27,879** | **(392)** | **27,485** |
| | | | | | | | | |
| Net revenue (expenses) from external customers | 2,973 | 36,367 | 6,647 | 579 | 3,304 | **49,870** | | |
| Net revenue (expenses) from other segments | 6,574 | (16,506) | 305 | 9,916 | (289) | **0** | | |
| **Total operating income (expense)** | **9,547** | **19,861** | **6,952** | **10,495** | **3,015** | **49,870** | | |
| | | | | | | | | |
| **Total assets at 31 December 2012** | **486,318** | **403,379** | **33,051** | **539,568** | **37,385** | **1,499,701** | **(414,916)** | **1,084,787** |
| **Total liabilities at 31 December 2012** | **449,839** | **330,373** | **28,833** | **428,179** | **37,313** | **1,274,537** | **(414,916)** | **859,621** |
| **Allocated capital at 31 December 2012** | **36,480** | **73,006** | **4,218** | **111,389** | **72** | **225,165** | **0** | **225,166** |

| 1 January - 31 December 2011 | Personal Banking | Corporate Banking | Markets | Treasury | All Other Segments | Total Segments | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 13,833 | 14,832 | (47) | 6,215 | (634) | **34,199** | (1,550) | **32,649** |
| Net adjustments in valuation | (25,166) | 2,024 | - | (422) | (23) | **(23,587)** | - | **(23,587)** |
| Net fee and commission income | 2,281 | 295 | 1,997 | 259 | (219) | **4,613** | (190) | **4,423** |
| Net gain on financial assets designated as at fair value through profit or loss | 37 | 5,304 | 10,759 | 1,452 | (93) | **17,459** | - | **17,459** |
| Net gain on financial assets and liabilities held for trading | - | - | (345) | 1,354 | - | **1,009** | - | **1,009** |
| Net foreign exchange gain (loss) | (439) | - | 243 | (854) | - | **(1,050)** | 291 | **(759)** |
| Other income and (expenses) | (976) | (171) | 29 | 171 | 500 | **(447)** | (3) | **(450)** |
| **Total operating income (expense)** | **(10,430)** | **22,284** | **12,636** | **8,175** | **(469)** | **32,196** | **(1,452)** | **30,744** |
| Total operating expenses | (12,954) | (3,704) | (1,973) | (1,942) | (1,693) | **(22,266)** | 210 | **(22,056)** |
| Share of profit of equity-accounted associates, net of income tax | 566 | (159) | - | 826 | 184 | **1,417** | - | **1,417** |
| **Profit (loss) before tax** | **(22,818)** | **18,421** | **10,663** | **7,059** | **(1,978)** | **11,347** | **(1,242)** | **10,105** |
| | | | | | | | | |
| Net revenue (expenses) from external customers | (15,594) | 39,018 | 12,713 | (3,829) | (113) | **32,195** | | |
| Net revenue (expenses) from other segments | 5,163 | (16,733) | (78) | 12,004 | (356) | **0** | | |
| **Total operating income (expense)** | **(10,431)** | **22,285** | **12,635** | **8,175** | **(469)** | **32,195** | | |
| | | | | | | | | |
| **Total assets at 31 December 2011** | **493,729** | **458,375** | **26,828** | **549,201** | **33,846** | **1,561,979** | **(426,497)** | **1,135,482** |
| **Total liabilities at 31 December 2011** | **458,538** | **376,625** | **19,030** | **473,696** | **33,846** | **1,361,735** | **(426,497)** | **935,238** |
| **Allocated capital at 31 December 2011** | **35,191** | **81,751** | **7,798** | **75,504** | **0** | **200,244** | **0** | **200,244** |

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## 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 2012:

| 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 | 25,898 | - | - | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | 113,203 | 100,950 | 14,055 | - | - | 228,208 | 228,208 |
| Equities and equity instruments | - | 1,107 | 35,774 | - | - | 36,881 | 36,881 |
| Derivative instruments | - | 1,043 | - | - | - | 1,043 | 1,043 |
| Loans and advances to financial institutions | 64,349 | - | - | - | - | 64,349 | 64,349 |
| Loans and advances to customers | 666,087 | - | - | - | - | 666,087 | 674,417 |
| Other financial assets | 10,481 | - | - | - | - | 10,481 | 10,481 |
| **Total** | **880,018** | **103,100** | **49,829** | **0** | **0** | **1,032,947** | **1,041,277** |
| **Financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | - | - | - | 98,718 | - | 98,718 | 98,718 |
| Deposits from customers | - | - | - | 421,058 | - | 421,058 | 420,856 |
| Derivative instruments and short positions | - | 9,438 | - | - | - | 9,438 | 9,438 |
| Secured bonds | - | - | - | 221,791 | - | 221,791 | 221,791 |
| Contingent bond | - | - | - | - | 87,474 | 87,474 | 87,474 |
| Other financial liabilities | - | - | - | 14,369 | - | 14,369 | 14,369 |
| **Total** | **0** | **9,438** | **0** | **755,936** | **87,474** | **852,848** | **852,646** |

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** |

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## 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 creditworthiness 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 2013 are estimated and payments after 2013 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

Deposits are recognised at amortised cost. The difference from fair value is the interest-rate dependent value adjustment calculated by comparing current market rates with original market rates of the deposits.

### Short positions

The short positions are bonds issud by the Icelandic government or public entities, with readily available quoted market price

### 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.

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

### Contingent bond

The fair value of the Contingent bond equals it's 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 Contingent bond since initial recognition.

### 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);
• 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 2012:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 63,751 | 40,643 | 10,611 | 115,005 |
| Equities and equity instruments | 4,212 | 2,792 | 29,877 | 36,881 |
| Derivative instruments | - | 1,043 | - | 1,043 |
| **Total** | **67,963** | **44,478** | **40,488** | **152,929** |
| **Financial liabilities** | | | | |
| Derivative instruments | - | 519 | - | 519 |
| Short positions | 8,919 | - | - | 8,919 |
| Contingent bond | - | - | 87,474 | 87,474 |
| **Total** | **8,919** | **519** | **87,474** | **96,912** |

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** |

During the year 2012 there were no transfers between individual levels.

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## 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 2012 and 2011:

| 1 January - 31 December 2012 | Bonds and debt instruments | Equities and equity instruments | Total financial assets | Contingent bond |
|---|---|---|---|---|
| Carrying amount at 1 January 2012 | 11,603 | 28,259 | 39,862 | (60,826) |
| Total gains (losses) recognised in income statement | 462 | 5,061 | 5,523 | (26,648) |
| Purchases | - | 2,629 | 2,629 | - |
| Sales | (40) | (6,281) | (6,321) | - |
| Settlements | (1,414) | 209 | (1,205) | - |
| **Carrying amount at 31 December 2012** | **10,611** | **29,877** | **40,488** | **(87,474)** |
| | | | | |
| **1 January - 31 December 2011** | | | | |
| 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 out of Level 3 | (61) | - | (61) | - |
| **Carrying amount at 31 December 2011** | **11,603** | **28,259** | **39,862** | **(60,826)** |

The following tables show the line items in the consolidated income statement where the total gains (losses) were recognised during the year 2012 and 2011, for fair value measurements in Level 3:

| 1 January - 31 December 2012 | Bonds and debt instruments | Equities and equity instruments | Contingent bond | Total |
|---|---|---|---|---|
| Fair value change of contingent bond | - | - | (27,331) | (27,331) |
| Net gain on financial assets designated as at fair value through profit or loss | 643 | 4,534 | - | 5,177 |
| Net foreign exchange gain (loss | (181) | 527 | 683 | 1,029 |
| **Total** | **462** | **5,061** | **(26,648)** | **(21,125)** |
| | | | | |
| **1 January - 31 December 2011** | | | | |
| 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 gain (loss) | 269 | 13 | - | 282 |
| **Total** | **(64)** | **13,097** | **(34,316)** | **(21,283)** |

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 2012 and categorised in Level 3, were recognised:

| | Bonds and debt instruments | Equities and equity instruments | Contingent bond | Total |
|---|---|---|---|---|
| Fair value change of contingent bond | - | - | (27,331) | (27,331) |
| Net gain on financial assets designated as at fair value through profit or loss | 156 | 3,455 | - | 3,611 |
| Net foreign exchange gain (loss) | 9 | 508 | 683 | 1,200 |
| **Total** | **165** | **3,963** | **(26,648)** | **(22,520)** |

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## 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 | 3,571 | (1,909) |
| Equities and equity instruments | 2,988 | (2,988) |
| **Total** | **6,559** | **(4,897)** |

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

| | 2012 | 2011 |
|---|---|---|
| Cash on hand | 2,749 | 2,355 |
| Reverse repurchase agreements with Central Bank | 21,178 | 4,010 |
| Unrestricted balances with Central Bank | - | 39 |
| **Total cash and unrestricted balances with Central Bank** | **23,927** | **6,404** |
| | | |
| Restricted balances with Central Bank | 1,971 | 2,419 |
| **Total cash and balances with Central Bank** | **25,898** | **8,823** |

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 7,262 million for December 2012 (December 2011: ISK 7,510 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.

## 9. Bonds and equities

| | 2012 | | | | 2011 | | | |
|---|---|---|---|---|---|---|---|---|
| **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 | 113,203 | 45,251 | 1,820 | 160,274 | 112,547 | 30,902 | 628 | 144,077 |
| Unlisted | - | - | 11,837 | 11,837 | - | 371 | 13,012 | 13,383 |
| | **113,203** | **45,251** | **13,657** | **172,111** | **112,547** | **31,273** | **13,640** | **157,460** |
| **Foreign** | | | | | | | | |
| Listed | - | 55,699 | - | 55,699 | - | 61,790 | 1,917 | 63,707 |
| Unlisted | - | - | 398 | 398 | - | - | 681 | 681 |
| | **0** | **55,699** | **398** | **56,097** | **0** | **61,790** | **2,598** | **64,388** |
| **Total bonds and debt instruments** | **113,203** | **100,950** | **14,055** | **228,208** | **112,547** | **93,063** | **16,238** | **221,848** |
| **Equities and equity instruments** | | | | | | | | |
| **Domestic** | | | | | | | | |
| Listed | - | 1,105 | 996 | 2,101 | - | 256 | 9,277 | 9,533 |
| Unlisted | - | - | 31,362 | 31,362 | - | - | 27,836 | 27,836 |
| | **0** | **1,105** | **32,358** | **33,463** | **0** | **256** | **37,113** | **37,369** |
| **Foreign** | | | | | | | | |
| Listed | - | 2 | 561 | 563 | - | 968 | 3,777 | 4,745 |
| Unlisted | - | - | 2,855 | 2,855 | - | - | 3,923 | 3,923 |
| | **0** | **2** | **3,416** | **3,418** | **0** | **968** | **7,700** | **8,668** |
| **Total equities and equity instruments** | **0** | **1,107** | **35,774** | **36,881** | **0** | **1,224** | **44,813** | **46,037** |
| **Total** | **113,203** | **102,057** | **49,829** | **265,089** | **112,547** | **94,287** | **61,051** | **267,885** |

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## 9. Bonds and equities (continued)

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 2012 and 2011 consist partly 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

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Notional | Fair value | | Notional | Fair value | |
| **Foreign exchange derivatives** | amount | Assets | Liabilities | amount | Assets | Liabilities |
| Currency forwards | 57,302 | 1,040 | 113 | 70,297 | 143 | 1,262 |
| Cross-currency interest rate swaps | 1,506 | - | 377 | 1,715 | - | 450 |
| | **58,808** | **1,040** | **490** | **72,012** | **143** | **1,712** |
| **Interest rate derivatives** | | | | | | |
| Total return swaps | 4,668 | 3 | 8 | 5,834 | 16 | 17 |
| | **4,668** | **3** | **8** | **5,834** | **16** | **17** |
| **Equity derivatives** | | | | | | |
| Total return swaps | 562 | - | 21 | - | - | - |
| | **562** | **0** | **21** | **0** | **0** | **0** |
| **Short positions - listed bonds** | **-** | **-** | **8,918** | **-** | **-** | **6,187** |
| **Total** | **64,038** | **1,043** | **9,438** | **77,846** | **159** | **7,916** |

The Group uses derivatives both for hedging and trading purposes.

## 11. Loans and advances to financial institutions

| | 2012 | 2011 |
|---|---|---|
| Bank accounts with financial institutions | 8,559 | 7,221 |
| Money market loans | 37,769 | 79,407 |
| Overdrafts | 7,726 | 3,857 |
| Other loans | 10,295 | 9,648 |
| **Total** | **64,349** | **100,133** |

## 12. Loans and advances to customers

| | 2012 | 2011 |
|---|---|---|
| Public entities | 11,682 | 12,143 |
| Individuals | 207,608 | 186,033 |
| Corporations | 490,827 | 469,374 |
| Less: Allowance for impairment | (44,030) | (28,420) |
| **Total** | **666,087** | **639,130** |

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

| **a) Investments in equity-accounted associates** | 2012 | 2011 |
|---|---|---|
| Carrying amount at the beginning of the year | 11,678 | 3,340 |
| Acquisitions through business combination | - | 234 |
| Acquisitions | 1,334 | 6,778 |
| Reclassification from assets held for sale | 2,665 | - |
| Share of profit of equity-accounted associates, net of income tax | 2,449 | 1,417 |
| Disposals | (2,598) | (91) |
| **Total** | **15,528** | **11,678** |

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### 13. Investments in associates (continued)

| At 31 December 2012* | Total assets | Total liabilities | Profit (loss) | Ownership interest | Share of profit of associates | Carrying amount |
|---|---|---|---|---|---|---|
| Valitor Holding hf. | 43,391 | 35,098 | 918 | 38% | 352 | 3,155 |
| Framtakssjóður Íslands slhf. | 29,526 | 118 | 6,014 | 28% | 1,660 | 8,113 |
| Reginn hf. | 28,004 | 16,811 | 533 | 25% | 133 | 2,798 |
| Borgun hf. | 20,599 | 18,548 | 654 | 31% | 204 | 660 |
| Reiknistofa bankanna hf. | 2,187 | 478 | 91 | 37% | 34 | 629 |
| Motus ehf. | 569 | 355 | 129 | 40% | 62 | 125 |
| Auðkenni hf. | 224 | 32 | 21 | 20% | 4 | 38 |
| Other | - | - | - | - | - | 10 |
| **Total** | **124,500** | **71,440** | **8,360** | | **2,449** | **15,528** |

| 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** |

*The amounts for the years 2011 and 2012 in the table above are estimated not actual amounts at the end of the respective years.

The subsidiary Reginn hf. was listed on the OMX Nordic Exchange in Iceland following a public offering in June 2012. 75% of the Group´s shares were sold in the public offering and the acquirers became shareholders of Reginn hf. on 29 June 2012. The Group has committed itself to hold the remaining 25% of the shares in Reginn hf. for minimum of 10 months from 29 June 2012. The shareholding in Reginn hf. is presented under „Investments in equity-accounted associates“ in the statement of financial position and the gain from the sale amounting to ISK 1,650 million is presented under the line item „Profit for the period from discontinued operations, net of income tax“ in the income statement.

All associates are unlisted companies except for Reginn hf., which is listed on the OMX Stock Exchange in Iceland. Based on its closing price of 11,0 at the reporting date, the fair value of the investment is ISK 3,575 million.

According to Framtakssjóður Íslands slhf. (FSI) the estimated fair value of the bank investment in FSI is higher than their carrying amount at year end 2012 by ISK 4,881 million.

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. At 31 December 2012 the Bank had invested in FSÍ ISK 8,842 (2011: 7,508) million representing 27.6% of total called in commitments ISK 32,048 milljon (2011: ISK 29,407 million). FSÍ is required to redeem its shareholders with the proceeds from sales of assets.

#### b) Investments in associates designated as at fair value through profit or loss

Four investments in associates 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”. Those investments are 49.5% shareholding in Promens hf., 29.6% shareholding in Reitir hf., 21.2% in Eyrir Invest hf. and 24.5% of the voting right in Stoðir hf.

### 14. Property and equipment

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Buildings | Fixtures, equipment and vehicles | Total | Buildings | Fixtures, equipment and vehicles | Total |
| Carrying amount at the beginning of the year | 4,531 | 1,906 | 6,437 | 3,299 | 1,717 | 5,016 |
| Acquisitions through business combination | - | - | - | 1,329 | 284 | 1,613 |
| Additions during the year | 61 | 788 | 849 | 2 | 375 | 377 |
| Sold during the year | (28) | (29) | (57) | - | (3) | (3) |
| Disposals | - | - | - | - | (68) | 68) |
| Depreciation | (98) | (355) | (453) | (99) | (399) | (498) |
| **Carrying amount at 31 December** | **4,466** | **2,310** | **6,776** | **4,531** | **1,906** | **6,437** |
| | | | | | | |
| Gross carrying amount | 4,820 | 5,158 | 9,978 | 4,789 | 4,375 | 9,164 |
| Accumulated depreciation | (354) | (2,848) | (3,202) | (258) | (2,469) | (2,727) |
| **Carrying amount at 31 December** | **4,466** | **2,310** | **6,776** | **4,531** | **1,906** | **6,437** |
| Depreciation rates | 2-4% | 10-33% | | 2-4% | 10-33% | |

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## 14. Property and equipment (continued)

| Official assessment value of buildings at 31 December | 2012 | 2011 |
|---|---|---|
| Official assessment value used for tax purposes | 4,998 | 3,823 |
| Replacement value used for insurance purposes | 12,556 | 8,774 |

| Depreciation and amortisation presented in the income statement consists of | 2012 | 2011 |
|---|---|---|
| Depreciation of property and equipment | 453 | 498 |
| Amortisation of intangible assets | 266 | 273 |
| **Total** | **719** | **771** |

## 15. Intangible assets

| Computer software licenses | 2012 | 2011 |
|---|---|---|
| Carrying amount at the beginning of the year | 681 | 877 |
| Additions | 126 | 77 |
| Amortisation | (266) | (273) |
| **Carrying amount at 31 December** | **541** | **681** |
| Amortisation rates | 20-33% | 20-33% |
| Gross carrying amount | 1,571 | 1,508 |
| Accumulated amortisation | (1,030) | (827) |
| **Carrying amount at 31 December** | **541** | **681** |

## 16. Other assets

| | 2012 | 2011 |
|---|---|---|
| Provisional amount of the bond to be issued by the National Treasury* | - | 30,596 |
| Legally disputed collections | 28 | 3,666 |
| Unsettled securities trading | 1,877 | 1,848 |
| Receivables from Framtakssjóður Íslands slhf. | - | 600 |
| Receivables from LBI hf. | 465 | 470 |
| Other accounts receivable | 2,814 | 1,403 |
| Claim on LBI hf. due to court ruling | 5,325 | - |
| Sundry assets | 3,599 | 5,418 |
| **Total** | **14,108** | **44,001** |

*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.

## 17. Assets and liabilities classified as held for sale

| | 2012 | 2011 |
|---|---|---|
| Repossessed collateral | 25,221 | 51,711 |
| Assets of disposal groups classified as held for sale | 99 | 1,841 |
| **Total** | **25,320** | **53,552** |

### 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 subsidiary Hömlur hf. During the second quarter of 2012 the Bank ceased its control of the subsidiary Reginn hf. due to sale of the Group's 75% shareholding in the company, see Note 13.

| | 31.12.2012 | 31.12.2011 |
|---|---|---|
| Carrying amount at the beginning of the year | 51,711 | 43,831 |
| Acquisitions through business combination | - | 2,304 |
| Repossessed during the period | 12,171 | 22,668 |
| Disposed during the period | (37,979) | (11,730) |
| Reclassification to equities and equity instruments | - | (4,390) |
| Impairment | (682) | (972) |
| **Carrying amount at the end of the year** | **25,221** | **51,711** |

### 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. During the first quarter of 2012 the Bank ceased its control of the subsidiary Vörður líftryggingar hf. due to a sale of the Bank's 11% shareholding in the company. The remaining shareholding was sold during the second quarter of 2012.

The profit (loss) for the period 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.

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## 18. Due to financial institutions and Central Bank

| | 2012 | 2011 |
|---|---|---|
| Loans and repurchase agreements with Central Bank | 180 | 40 |
| Loans and deposits from financial institutions | 98,538 | 112,836 |
| **Total** | **98,718** | **112,876** |

## 19. Deposits from customers

| | 2012 | 2011 |
|---|---|---|
| Demand deposits | 310,088 | 344,952 |
| Time deposits | 110,970 | 98,638 |
| **Total** | **421,058** | **443,590** |

## 20. Secured bonds

| | Nominal amount | | | | | Carrying amount | |
|---|---|---|---|---|---|---|---|
| | Foreign currency | | ISK | | Contractual | ISK | |
| **Secured bonds** | **2012** | **2011** | **2012** | **2011** | **interest rate (%)** | **2012** | **2011** |
| EUR | 649 million | 871 million | 109,730 | 138,281 | EURIBOR + 1.75/2.90 | 109,380 | 136,818 |
| GBP | 205 million | 275 million | 42,503 | 52,330 | LIBOR + 1.75/2.90 | 42,397 | 51,702 |
| USD | 548 million | 734 million | 70,186 | 89,741 | LIBOR + 1.75/2.90 | 70,014 | 88,556 |
| **Total** | | | **222,419** | **280,352** | | **221,791** | **277,076** |

On 12 October 2010 the Bank issued secured bonds to LBI 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 2012 and 2011 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 original scheduled quarterly instalments starting in 2014. As a result of prepayment of principals of the bonds in June 2012 the next instalments are scheduled for April 2015. 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.

On 29 February 2012 the Bank made a mandatory early redemption amount of ISK 1,615 million, due to a clause on Asset Disposition. The Bank shall redeem such part of the principal amount of the bonds as is equal to 50% of excess disposal amounts in regards to asset dispositions, subject to a maximum redemption amount.

On 15 June 2012 the Bank made an optional and partial pre-payment of 25% of the principal of each of the above bonds in the amount of EUR 216 million, GBP 68 million and USD 183 million, plus accrued interest from the last interest payment date to the partial early repayment date. The pre-payment of principal shall be considered as payment of the first five out of twenty scheduled principal payments of each bond. The next repayment of the principal will thus be in April 2015 instead of January 2014. This results in decreased pools of loans which the Bank has to pledge for the bonds, see Note 38.

## 21. Contingent bond

Pursuant to the provisions of the settlement agreement between the Bank, LBI hf. and the Icelandic State of 15 December 2009, the Bank shall issue a bond to LBI hf. no later than 31 March 2013, as an additional consideration for the assets and liabilities transferred from LBI hf. to the Bank on 9 October 2008. The value of the bond is contingent on the excess fair value of certain pools of assets as at 31 December 2012 over the future value of their acquisition price as at 9 October 2008, subject to specified adjustments. As at 31 December 2012 the Bank's estimate of the nominal amount of the contingent bond was ISK 88,142 million, which is lower than the bond's nominal ceiling amount of ISK 92,000 million. The estimate is that of the management of the Bank but the final and binding amount of the bond is still being determined by an independent third-party valuation agent, whose conclusions are expected to be presented no later than 31 March 2013. The Bank will issue the bond to LBI hf. no later than 31 March 2013, based on the valuation agent's final amount, converted into Euros at the exchange rate as published by the Central Bank of Iceland on 31 December 2012. The bond bears floating interest and matures in October 2018 with quarterly instalments starting in 2014.

Any possible difference between the Bank's estimate in these financial statements and the third-party valuation agent's final and binding amount will be accounted for in the Bank's 2013 first quarter financial statements. Given the nominal ceiling amount of ISK 92,000 million, the increase in the Group's total liabilities due to this is capped at ISK 3,858 million (using the EUR/ISK exchange rate at 31 December 2012). Whatever the final valuation difference will be, it is likely to be counter-balanced by improved recoverability of the Group's loans, such that the impact on the Group's 2013 performance will not be significant. However, any such changes in the underlying assets and the contingent bond may not necessarily be accounted for in the same quarterly financial statements.

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### 21. Contingent bond (continued)

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. As of 1 January 2013 the contingent bond is reclassified as a secured bond issued by the Bank and measured at amortised cost at the effective interest rate of LIBOR+2.9% to maturity.

### 22. Tax assets and liabilities

Tax assets and liabilities are specified as follows:

| Tax assets | 2012 | 2011 |
|---|---|---|
| Deferred tax assets | 48 | 3,003 |
| **Tax liabilities** | | |
| Current tax liabilities | 0 | 70 |

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

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Net | Assets | Liabilities | Net |
| Property and equipment | - | (1,061) | (1,061) | - | (1,332) | (1,332) |
| Intangibles | - | (105) | (105) | - | (17) | (17) |
| Loans and advances to customers | 450 | - | 450 | 3,640 | - | 3,640 |
| Deferred foreign exchange differences | - | (342) | (342) | - | (1,259) | (1,259) |
| Other items | - | (68) | (68) | - | (348) | (348) |
| Tax losses carried forward | 1,174 | - | 1,174 | 2,319 | - | 2,319 |
| | **1,624** | **(1,576)** | **48** | **5,959** | **(2,956)** | **3,003** |
| Set-off of deferred tax assets together with liabilities of the same taxable entities | (1,575) | 1,575 | - | (2,956) | 2,956 | - |
| **Total** | **49** | **(1)** | **48** | **3,003** | **0** | **3,003** |

The deferred tax assets and liabilities are measured based on the tax rates and tax laws enacted by the end of 2012, according to which the domestic corporate income tax rate was 20% as at 31 December 2012 (2011: 20%).

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

| | | Recognised in income statement | | |
|---|---|---|---|---|
| 2012 | Balance 1.1 | Tax (expense) income | Changes from prior year | Balance 31.12 |
| Property and equipment | (1,332) | 271 | - | (1,061) |
| Intangibles | (17) | (88) | - | (105) |
| Loans and advances to customers | 3,641 | (3,191) | - | 450 |
| Deferred foreign exchange differences | (1,259) | 917 | - | (342) |
| Other items | (348) | 273 | 8 | (67) |
| Tax losses carried forward | 2,318 | (2,107) | 960 | 1,172 |
| **Total** | **3,003** | **(3,925)** | **968** | **48** |
| **2011** | | | | |
| Property and equipment | (1,943) | 589 | 22 | (1,332) |
| Intangibles | (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** |

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## 23. Other liabilities

| | 2012 | 2011 |
|---|---|---|
| Excess payments on lease and loan agreements | 8,857 | 11,156 |
| Unsettled securities trading | 3,873 | 4,852 |
| Withholding tax | 2,121 | 2,165 |
| Accounts payable | 1,293 | 1,348 |
| Contribution to the Depositors' and Investors' Guarantee Fund | 270 | 348 |
| Tax on liabilities of financial institutions | 300 | 35 |
| Sundry liabilities | 3,535 | 3,595 |
| **Total** | **20,249** | **23,499** |

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 0.05625% of all guaranteed deposits in the Bank, as defined in the amendment of the Act from 19 June 2012. 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 2012 amounts to ISK 270 million to be paid no later than 1 March 2013 (31 December 2011: ISK 348 million).

## 24. Equity

*Share capital*

The total number of ordinary shares authorised and issued by the Bank at year end 2012 and 2011 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 aquisition price for the domestic operations of LBI hf., the Bank issued senior secured bonds (see Notes 20 and 38). If the Bank makes a dividend payment then it shall redeem or shall have redeemed (such redemption not having been required by any other provision hereof) the bonds on a pro-rata basis in an amount equal to such dividend payment. In June 2012, the Bank made an optional and partial prepayment of principal of each of the bonds in an amount equivalent to ISK 71,200 million. In consequence of the Bank having redeemed part of the principal of the bonds with an optional prepayment, future dividend payments (and other payments of similar nature) up to ISK 71,200 million will not require further early redemptions of the bonds.

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.

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## Notes to the Consolidated Income Statement

### 25. Net interest income

| Interest income | 2012 | 2011 |
|---|---|---|
| Cash and balances with Central Bank | 1,091 | 1,186 |
| Bonds and debt instruments classified as loans and receivables | 4,921 | 3,768 |
| Loans and advances to financial institutions | 585 | 938 |
| Loans and advances to customers | 57,131 | 54,672 |
| Other interest income | 933 | 267 |
| **Total** | **64,661** | **60,831** |
| **Interest expense** | | |
| Due to financial institutions and Central Bank | (2,048) | (2,139) |
| Deposits from customers | (16,485) | (15,225) |
| Secured bonds | (10,482) | (10,653) |
| Other interest expense | (62) | (165) |
| **Total** | **(29,077)** | **(28,182)** |
| **Net interest income** | **35,584** | **32,649** |
| Interest spread (as the ratio of net interest income to the average carrying amount of total assets during the year). | **3.2%** | **2.9%** |
| Adjusted interest spread (as the ratio of net interest income after net adjustments in valuation to the average carrying amount of total assets during the year). | **2.8%** | **0.8%** |

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

| | 2012 | 2011 |
|---|---|---|
| Net adjustments to loans and advances acquired at deep discount | 37,320 | 58,489 |
| Loss from foreign currency linkage of loans and advances to customers | (2,120) | (40,726) |
| Net impairment loss | (12,260) | (7,034) |
| **Total** | **22,940** | **10,729** |
| Individuals | (233) | (14,920) |
| Corporations | 23,173 | 25,649 |
| **Total** | **22,940** | **10,729** |

### 27. Net fee and commission income

| Fee and commission income | 2012 | 2011 |
|---|---|---|
| Investment banking and capital markets | 1,223 | 1,287 |
| Asset management | 1,009 | 1,022 |
| Lending | 1,060 | 981 |
| Cards | 1,524 | 1,385 |
| Interbank clearing | 1,079 | 991 |
| Collection and payment services | 792 | 790 |
| Foreign trade | 638 | 524 |
| Other commissions and fees | 371 | 457 |
| **Total** | **7,696** | **7,437** |
| **Fee and commission expense** | | |
| Investment banking and capital markets | (316) | (252) |
| Interbank clearing | (1,082) | (988) |
| Other fees | (1,850) | (1,774) |
| **Total** | **(3,248)** | **(3,014)** |
| **Net fee and commission income** | **4,448** | **4,423** |

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. Moreover, it does not include any net fee and commission income relating to such financial assets and liabilities.

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

| | 2012 | 2011 |
|---|---|---|
| Bonds and debt instruments | 740 | 1,319 |
| Equities and equity instruments | 4,963 | 16,140 |
| **Total** | **5,703** | **17,459** |

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

| | 2012 | 2011 |
|---|---|---|
| Bonds and debt instruments | 2,200 | 1,749 |
| Equities and equity instruments | 205 | (388) |
| Derivative instruments | (236) | (352) |
| **Total** | **2,169** | **1,009** |

## 30. Dividend income

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

| | 2012 | 2011 |
|---|---|---|
| Net gain on financial assets designated as at fair value through profit or loss | 531 | 488 |
| Net gain on financial assets and liabilities held for trading | 20 | 110 |
| **Total** | **551** | **598** |

## 31. Net foreign exchange gain (loss)

| **Assets** | 2012 | 2011 |
|---|---|---|
| Cash and balances with Central Bank | 56 | 7 |
| Bonds and debt instruments | 4,972 | 3,315 |
| Equities and equity instruments | 1,085 | 168 |
| Derivative instruments | 2,438 | (2,772) |
| Loans and advances to financial institutions | 2,643 | 2,797 |
| Loans and advances to customers | 9,465 | 12,729 |
| Other assets | 1,194 | 192 |
| **Total** | **21,853** | **16,436** |
| | | |
| **Liabilities** | | |
| Due to financial institutions and Central Bank | (1,347) | 167 |
| Deposits from customers | (3,281) | (5,047) |
| Secured bonds | (12,631) | (12,308) |
| Other liabilities | (28) | (7) |
| **Total** | **(17,287)** | **(17,195)** |
| | | |
| **Net foreign exchange gain (loss)** | **4,566** | **(759)** |

The foreign exchange differences which were recognised during the year 2012 in the consolidated income statement and arose on financial instruments not measured at fair value through profit or loss, amounted to a ISK 13,304 million gain for financial assets (2011; gain 15,725 million) and loss of ISK 15,940 million for financial liabilities (2011: loss of ISK 5,778 million).

## 32. Other income and expenses

| | 2012 | 2011 |
|---|---|---|
| Recharged expenses | 235 | 324 |
| Gain (loss) on sale of property and equipment | 14 | (61) |
| (Loss) on assets classified as held for sale | (176) | (1,030) |
| Other | 989 | 317 |
| **Total** | **1,062** | **(450)** |

## 33. Salaries and related expenses

| | 2012 | 2011 |
|---|---|---|
| Salaries | 10,224 | 9,618 |
| Contributions to defined contribution pension plans | 1,365 | 1,320 |
| Other personnel expenses | 1,587 | 1,052 |
| **Total** | **13,176** | **11,990** |
| | | |
| Number of full-time equivalent positions at year end | 1,233 | 1,311 |
| Average number of full-time equivalent positions during the year | 1,260 | 1,283 |

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## Notes to the Consolidated Financial Statements

### 34. Other operating expenses

| | 2012 | 2011 |
|---|---|---|
| Software licensing and other information technology costs | 2,025 | 2,067 |
| Real estate and fixtures | 1,150 | 967 |
| Advertising and marketing | 736 | 739 |
| Operating lease rentals | 660 | 553 |
| FME supervisory expenses | 417 | 335 |
| Contribution to the Debtor's Ombudsman | 203 | 182 |
| Audit and related services | 130 | 178 |
| Other professional services | 879 | 884 |
| Other operating expenses | 2,678 | 2,562 |
| **Total** | **8,878** | **8,467** |

| **Audit and related services** | 2012 | 2011 |
|---|---|---|
| Audit of financial statement and audit related service | 79 | 121 |
| Review of interim financial statement | 51 | 54 |
| Other services | - | 3 |
| **Total** | **130** | **178** |

### 35. Acquisition-related costs

| | 2012 | 2011 |
|---|---|---|
| Cost of acquisition of assets and liabilities from SpKef hf. | - | 245 |
| Cost of acquisition of assets and liabilities from LBI hf. | 290 | - |
| **Total** | **290** | **245** |

### 36. Income tax and other taxes

Income tax is recognised based on the tax rates and tax laws enacted during the current year, according to which the domestic corporate income tax rate was 20.0% (2011: 20.0%). An additional special income tax on pre-tax profit over ISK 1,000 million at a rate of 6.0% is imposed on financial institutions for the first time in 2012.

*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 2012 amounts to ISK 1,200 million. The additional tax was recognised in the consolidated financial statements of the Group for the year 2012.

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

| | 2012 | 2011 |
|---|---|---|
| Current tax expense | - | (70) |
| Difference of prior year's imposed and calculated income tax | 1,087 | 913 |
| Deferred tax expense | (4,012) | 568 |
| **Total** | **(2,925)** | **1,411** |

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

| | 2012 | | 2011 | |
|---|---|---|---|---|
| Profit before tax | | 27,485 | | 10,105 |
| Tax on liabilities of financial institutions | | (1,200) | | (814) |
| Profit before income tax | | 26,285 | | 9,291 |
| Income tax calculated using the domestic corporate income tax rate | 20.0% | (5,257) | 20.0% | (1,858) |
| Income not subject to tax | (5.2%) | 1,357 | (33.2%) | 3,080 |
| Non-deductable expenses | 1.4% | (371) | 1.3% | (118) |
| Other* | (5.1%) | 1,346 | (3.3%) | 307 |
| **Effective income tax** | **11.1%** | **(2,925)** | **(15.2%)** | **1,411** |

*The 2012 amount is due to revaluation of deferred tax assets whereas the 2011 amount is due to other tax sources.

Tax exclusively imposed on financial institutions is specified as follows:

| | 2012 | 2011 |
|---|---|---|
| Special financial activities tax on salaries* | (620) | - |
| Tax on liabilities of financial institutions** | (1,200) | (814) |
| **Total** | **(1,820)** | **(814)** |

*The Special financial activities tax on salaries at a rate of 5.45% is expensed in the line item "Salaries and related expenses" in the income statement.

**The Tax on liabilities of financial institutions is paid annually at a rate of 0.041% of the carrying amount of liabilities as determined for tax purposes. Additional tax of 0.0875% on the same tax base is imposed in respect of the years 2011 and 2012.

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## Other notes

### 37. Litigation

The status of legal proceedings relating to the Group at year end 31 December 2012 is the following:

#### a) Litigation concluded in 2012 and early 2013

1) In September 2009, Handelsbanken AB, a Swedish bank, commenced litigation before the District Court of Reykjavík against the Bank, demanding a payment of ISK 835 million (SEK 42.4 million) plus interest based on a sub-guarantee issued by LBI hf. (previously Landsbanki Íslands hf.) to Handelsbanken. The District Court of Reykjavík ruled in favour of the Bank with reference to a decision of the FME dated 19 October 2008 stating that sub-guarantees such as this was not transferred from LBI to the Bank. Handelsbanken AB appealed the District Court's ruling to the Supreme Court which reversed the ruling in favour of Handelsbanken AB. The Court's decision was based on the fact that the Bank transmitted a SWIFT message to Handelsbanken AB on 23 October 2008 stating that the Bank was the guarantor. The Court found that even though the sub-guarantee had not been transferred to the Bank according to FME decision on 19 October 2008 the Bank had become a guarantor by sending the SWIFT message on 23 October and therefore obligated to pay the claimed amount. After the Bank paid Handelsbanken AB the claimed amount, Handelsbanken AB transferred to the Bank its claim on the estate of LBI in liquidation.

2) In March 2009 the Spanish bank Aresbank commenced litigation against the Bank, submitting claims to the District Court of Reykjavík demanding the Bank to pay ISK 5,069 million (EUR 30 million) and ISK 1,451 million (GBP 7 million), in addition to interests and litigation costs and that, alternatively that the FME and the Icelandic State are to pay damages on the basis of tort. The case involved two money market loans to LBI hf. each amounting to ISK 2,534 million (EUR 15 million) and a third money market loan amounting to ISK 1,451 million (GBP 7 million). In short, Aresbank claimed that money market loans were to be considered deposits according to the Act on Deposit Insurance, No. 98/1999. Aresbank cited the Icelandic government's declaration of 6 October 2008, that states that the government guarantees all deposits in domestic commercial banks and their branches in Iceland. On 22 December 2010 the District Court of Reykjavík ruled in favour of the Bank and confirmed that money market loans are not deposits according to the Act on Deposit Insurance. 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 whether "money market loans" fall there within. The EFTA Court delivered its opinion at the end of 2012, subsequently proceedings continued before the Icelandic Supreme Court which ruled in favour of the Bank and dismissed all claims made by Aresbank.

3) In May 2011 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 amounted to ISK 1,200 million plus interest. On 6 October 2008, the Icelandic Parliament, Althingi, adopted Act No. 125/2008, authorising the FME 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 LBI on 7 October 2008. Landsvaki's money-market-fund "Peningabréf ISK" was closed on 6 October 2008 in accordance with an FME decision. 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 deposits accordingly. The claim was that Landsvaki should compensate the remaining 31.2% (ISK 1,200 million). 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 instructions should have been executed before the fund was closed on Monday 6 October 2008. After the first hearing before the District Court the City of Reykjavik withdrew the case.

4) 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 was 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. On 11 July 2012 ESA concluded its investigation and approved the state aid granted for the restructuring of the Bank.

5) On 15 December 2010 ESA opened a formal investigation on state aid granted in October 2008 and September 2009 to rescue domestic operations of the three main Icelandic banks. On 11 July 2012 ESA concluded its investigation and with reference to the serious disturbance in the Icelandic economy at the time ESA found the aid compatible with the EEA Agreement.

### 37. Litigation (continued)

6) In December 2009 documents were served on the Bank by Basler Kantonalbank (BKB), a bank of the Swiss canton Basel City. Written summons were 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 2,687 million (CHF 19,2 million) plus 5% interest from 9 October 2008, and is for the non-performance of FX Swap transactions by LBI. BKB argues that according to an FME decision the Bank took over LBI rights and obligations under derivatives contracts. BKB also argues that the FME decision of 12 October 2008, whereby the decision of 9 October was amended to the effect 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 LBI. Court proceedings began in the fall of 2012 with a settlement procedure involving an opinion of an impartial judge. The opinion was favorable to the Bank and in February 2013 BKB relinquished the claim.

#### b) Ongoing Litigation

7) Fortis Bank was a correspondent bank of LBI hf. for international payments. The account had also been used by customers of LBI for international payments. After the foundation of the Bank, Fortis Bank was repeatedly notified thereof and that a resolution committee had been appointed for LBI on 7 October 2008. Fortis Bank was instructed not to receive payments into the account as the transferred payments were in fact owned by customers of the Bank. Fortis Bank did not act on the instructions and continued to receive payments and crediting the account of LBI. The Bank's customers who did not receive their payments due to the actions of Fortis Bank were reimbursed by the Bank. Of those customers, ten individual account holders were selected to commence litigation against Fortis Bank. On 23 May 2012 the Commercial Court of Brussels ruled in favour of the account holders ordering that Fortis Bank pay the total amount of ISK 372 million (EUR 2,2 million). Fortis bank has now appealed the court's decision to a higher court. It is foreseeable that the proceedings will be ongoing at least until 2014.

8) In May 2012 Stígandi ehf., a limited liability company, commenced litigation against the Bank. In the year 2007 Stígandi's CEO signed three loan agreements on behalf of the company (total amount ISK 2,302 million when the summons were filed). Now the board of directors claims that the CEO acted alone without consent of the board. The person who signed the loan agreements is still the CEO of Stígandi, holds 25% of Stígandi's shares and is on the board of directors together with his parents and brothers. Stígandi demands that the loan agreements be found invalid by the District Court of Reykjavík as well as repayment of ISK 13 million plus interest. Alternatively Stígandi claims damages amounting to ISK 2,302 million from the Bank plus interest. The Bank takes the view that the claims are without merit. It is foreseeable that the case will be heard by the District Court of Reykjavík in the early months of 2013.

9) In November 2011 Norðurturn ehf. (Norðurturn) a limited liability company in liquidation commenced litigation against Eignarhaldsfélag Smáralindar ehf. a limited liability company owned by Reginn hf. (previously 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. Norðurturn now claims that the construction was done in accordance with an agreement between Norðurturn and Eignarhaldsfélag Smáralindar. Norðurturn's claim amounts to ISK 1,300 million plus interest. On behalf of Eignarhaldsfélag Smáralindar it is argued that there was no such agreement. The Bank has issued a guarantee for payment of the disputed amount on behalf of Eignarhaldsfélag Smáralindar if the case were to be lost. On 21 November 2012 the District Court ruled in favour of Eignarhaldsfélag Smáralindar. Norðurturn has expressed its intention to appeal the ruling to the Supreme Court.

10) In the year 2012 Plastiðjan ehf. a limited liability company commenced litigation against the Bank. In light of the Supreme Court rulings on the illegality of loans indexed to foreign currency the Bank recalculated loans to their customers. The dispute regards the method on how to recalculate Plastiðjan's interest payments. The disputed amount is approximately ISK 1 million but the Court's ruling on the method of recalculation is likely to affect other similar loans owned by the Bank which might call for new recalculations. Based on the Supreme Court's rulings in cases No. 600/2011 and 464/2012 regarding interest payments, an additional claim for payment must be considered substantial in order to fall under the precedence. In the case of Plastiðjan the Bank takes the view that the amount is insubstantial and therefore the recalculation to be correct. The District Court ruled in favour of the Bank but Plastiðjan has expressed its intention to appeal the ruling to the Supreme Court.

11) In December 2012 Ísleifur Jónsson, EP fjármál ehf., Upsir ehf. and Magnús Ingi Erlingsson commenced litigation against the Bank claiming damages in the amount of ISK 943 million plus interest. The plaintiffs were shareholders in the limited liability company Nýja Jórvík ehf., a company that was established for the purpose of buying in 2002 a rundown industrial building at Mýrargata 26 in Reykjavík, demolishing it and rebuilding on the same land a luxury apartment building. LBI and Nýja Jórvík entered into a loan agreement in 2005 for a total ISK 1,130 million where LBI agreed to lend money on terms relating to the progress and total building cost of the project. In the summer of 2008 the loans' principal had reached its maximum and Nýja Jórvík asked for another loan to continue the construction. At that time the market for real estate had crashed and building cost had increased significantly. On those grounds LBI declined Nýja Jórvík's request for a new loan and on the grounds that Nýja Jórvík was unable to provide increased equity. In 2010 Nýja Jórvík was declared bankrupt after not being able to pay its main contractor. The Plaintiffs claim that they lost the claimed amount when Nýja Jórvík went bankrupt because the loan agreement was illegally indexed to foreign currency. The Bank takes the view, first, that the plaintiffs cannot claim damages which supposedly Nýja Jórvík incurred. Second, eventually that such a claim should be directed at LBI. Third, that there was no damage incurred by the plaintiffs. Fourth, that the Bank is not liable if there was damage. The Bank has submitted its defence and it is foreseeable that the case will be heard before the District Court of Reykjavík in the spring of 2013.

### 37. Litigation (continued)

12) In December 2012 Visir hf., a limited liability company, commenced litigation against the Bank. Visir claims that its loan should be recalculated as a loan in ISK, illegally indexed to foreign currency. The Bank takes the view that the loan is a legitimate foreign currency loan and should not be recalculated in accordance with legislation No. 151/2010 and the Supreme Court's precedence. The Bank argues inter alia that all payments of Visir to the Bank, based on the loan agreement, were in foreign currency. It is expected that the case will be heard before the District Court of Reykjavík in the early months of 2013.

13) In June 2012 Reynir Finndal Grétarsson commenced litigation against the Bank. Mr. Grétarsson claims that his loan should be recalculated as a loan in ISK, illegally indexed to foreign currency. The Bank takes the view that the loan is a legitimate foreign currency loan and should not be recalculated in accordance with legislation No. 151/2010 and the Supreme Court´s precedence. The Bank argues inter alia that the loan was paid out in foreign currency, not ISK. It is expected that the case will be heard before the District Court of Reykjavík in the early months of 2013.

14) In March 2012 Flugastraumur ehf., a limited liability company, commenced litigation against the Bank. Flugastraumur maintains that its lease should be regarded as a loan agreement denominated in ISK and indexed to foreign currency and recalculated as such. The Bank's view is that the contract is in fact a lease contract that can be legally indexed to foreign currency in accordance with precedence of the Supreme Court. It is foreseeable that the case will be heard by the District Court in the early months of 2013.

15) In November 2012 Landsbankinn Guernsey Ltd. commenced litigation against the Bank, the FME and the Icelandic government. The plaintiff claims are that the Bank pay approximately ISK 2,694 million (GBP 13 million), ISK 106 million (EUR 628 thousand) and ISK 397 million (USD 3,1 million) plus interest, based on money market loans between the plaintiff and LBI that were transferred to the Bank with FME´s decision on 9 October 2008. After the Supreme Court's judgement of 17 January 2013, in the case of Aresbank, the plaintiff has expressed its view that it will withdraw its summons against FME and the Icelandic government. The case will however continue against the Bank. The plaintiff claims that money market loans are to be considered deposits according to the Act on Deposit Insurance, No. 98/1999. The plaintiff cites the Icelandic government's declaration from 9 October 2008, that states that the government guarantees all deposits in domestic commercial banks and their branches in Iceland. The Bank´s view is that money market loans were not transferred to the Bank on 9 October 2008 with FME's decision. This is based on the Supreme´s Court conclusion after reviewing all facts in the case of Aresbank. The Bank has not yet submitted written arguments but it is foreseeable that the case will be heard by the District Court of Reykjavík in the spring of 2013.

16) In December 2012 fourteen foreign banks commenced litigation against the Bank claiming payment of damages of approximately ISK 338 million (EUR 2 million). The plaintiffs base their claim on a syndicated loan to Samson, a limited liability company, that later underwent bankruptcy proceedings. When the plaintiffs submitted their claim to the liquidator of Samson's estate they failed to provide details on pledged assets. As a result of this failure the previously pledged assets were distributed to claimants of the estate as if they were not pledged assets in accordance with the Act on Bankruptcy, etc. No. 21/1991. The plaintiffs commenced legal action against the liquidator and in August 2011 Supreme Court ruled in favour of the liquidator. The plaintiffs now argue that the Bank should not have given the liquidator access to the previously pledged assets and is therefore liable for damages. The Bank takes the view that it only operated in accordance with Act on Bankruptcy and that the plaintiffs failure to correctly submit their claims to the bankrupt estate of Samson cannot create a liability for the Bank. The case is in its early stages and the Bank has not yet submitted its defence. It is foreseeable that the case will be heard by the District Court of Reykjavík in 2013.

17) 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. In June 2012 the District Court found in favour of the Bank and dismissed all claims made by Hestafl. Hestafl has appealed the judgment to the Supreme Court and it is expected that the case will be heard by the Court in the spring of 2013.

18) In May 2012 LBI hf. commenced litigation against the Bank's subsidiary, Landsvaki hf., based on the Act on Bankruptcy etc. No. 21/1991, claiming rescission of the purchase by LBI of bonds in the amount of approximately ISK 25,000 milion. Moreover, with respect to these claims, LBI claimed a set-off in the amount of ISK 5,000 million against a claim of the Bank that has been acknowledged in a Supreme's Court ruling of 22 March 2012. Landsvaki rejects the claims of LBI arguing that Landsvaki acted only in accordance with law and in collaboration with the FME. Furthermore, the Bank rejects the set-off claim as not being admissible in this case. The case will be heard by the District Court of Reykjavík in the early months of 2013.

### 37. Litigation (continued)

19) In October 2012 Kaupthing hf. commenced litigation before the District Court of Reykjavík against Landsbréf hf., Landsbanki Structured Finance III and Landsvaki hf. Kaupthing's claim amounts to ISK 724 million based on a derivative contract between Kaupthing and Landssjóður hf., dated 28 February 2008. Landssjóður's operating company was at that time the Bank's subsidiary Landsvaki. On 13 November 2008 Kaupthing informed Landsvaki that Landsvaki owed Kaupthing ISK 747 million as a final settlement based on the derivative contract. On 9 October 2008 a Resolution Committee was appointed for the estate of Kaupthing in accordance with Act. No. 125/2008 which has now jointly direct Kaupthing's estate with its Winding-up Board. Landsvaki filed a claim to the Winding-up Board based on a bond issued by Kaupthing amounting to ISK 1,282 million (USD 10 million) and declared set off against Kaupthing's claim based on the derivative contract. The Winding-up Board rejected Landsvaki's claim and declaration of set off. Landsbréf hf., Landsbanki Structured Finance III and Landsvaki have not yet submitted their comments on the case as it is in the initial stage of proceedings.

20) On 16 September 2011 Arion bank hf. lodged a complaint to EFTA Surveillance Authority (ESA) on the grounds of an alleged infringement of EEA state aid rules claiming that Landsbankinn through state resources has an advantage on the market. It was claimed that the Bank distributed funds to 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.

### 38. Encumbered assets

On 12 October 2010 the Bank and LBI 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 LBI hf. The Bank must maintain a minimum cover ratio of 127.5% for the secured bonds. Once the contingent bond has been issued, the Bank must pledge assets for the contingent 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.

| | Encumbered | | | |
|---|---|---|---|---|
| **At 31 December 2012** | **Pledged as collateral against secured bonds** | **Other*** | **Un-encumbered** | **Total** |
| Cash and balances with Central Bank | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | - | 17,821 | 210,387 | 228,208 |
| Equities and equity instruments | - | - | 36,881 | 36,881 |
| Derivative instruments | - | - | 1,043 | 1,043 |
| Loans and advances to financial institutions | - | 8,091 | 56,258 | 64,349 |
| Loans and advances to customers | 319,240 | - | 346,847 | 666,087 |
| Investments in equity- accounted associates | - | - | 15,528 | 15,528 |
| Property and equipment | - | - | 6,776 | 6,776 |
| Intangible assets | - | - | 541 | 541 |
| Deferred tax assets | - | - | 48 | 48 |
| Other assets | - | - | 14,108 | 14,108 |
| Assets classified as held for sale | - | - | 25,320 | 25,320 |
| **Total** | **319,240** | **25,912** | **739,635** | **1,084,787** |

| | Encumbered | | | |
|---|---|---|---|---|
| **At 31 December 2011** | **Pledged as collateral against secured bonds** | **Other*** | **Un-encumbered** | **Total** |
| Cash and balances with Central Bank | - | - | 8,823 | 8,823 |
| Bonds and debt instruments | 27,490 | 18,647 | 175,711 | 221,848 |
| Equities and equity instruments | - | - | 46,037 | 46,037 |
| Derivative instruments | - | - | 159 | 159 |
| Loans and advances to financial institutions | - | 5,892 | 94,241 | 100,133 |
| Loans and advances to customers | 337,959 | - | 301,171 | 639,130 |
| Investments in equity-accounted associates | - | - | 11,678 | 11,678 |
| Property and equipment | - | - | 6,437 | 6,437 |
| Intangible assets | - | - | 681 | 681 |
| Deferred tax assets | - | - | 3,003 | 3,003 |
| Other assets | - | - | 44,001 | 44,001 |
| Assets classified as held for sale | - | - | 53,552 | 53,552 |
| **Total** | **365,449** | **24,539** | **745,494** | **1,135,482** |

*Other represents assets pledged as collateral to the Central Bank of Iceland to secure settlement in the Icelandic clearing systems, assets pledged as collateral to secure trading lines and credit support for ISDA master agreements and other pledges of similar nature.

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## 39. Leasing

### Operating lease commitments where the Group is lessee

In cases where the Group is a lessee, the future minimum lease payments under none-cancellable operating leases on 31 December were as follows:

| | 2012 | 2011 |
|---|---|---|
| Less than one year | 219 | 47 |
| Between one and five years | 292 | 339 |
| More than five years | 158 | 183 |
| **Total** | **669** | **569** |

### 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 none-cancellable operating leases on 31 December were as follows:

| | 2012 | 2011* |
|---|---|---|
| Less than one year | 139 | 193 |
| Between one and five years | 206 | 286 |
| More than five years | 18 | 25 |
| **Total** | **363** | **504** |

### 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 2012 | Gross investment in finance lease | Future finance income | Present value of minimum lease |
|---|---|---|---|
| Less than one year | 1,567 | (153) | 1,414 |
| Between one and five years | 2,710 | (210) | 2,500 |
| More than five years | 354 | (27) | 327 |
| **Total** | **4,631** | **(390)** | **4,241** |
| **At 31 December 2011*** | | | |
| Less than one year | 1,713 | (167) | 1,546 |
| Between one and five years | 2,963 | (229) | 2,734 |
| More than five years | 387 | (30) | 95 |
| **Total** | **5,063** | **(426)** | **4,375** |

*One of the assumptions for the year 2011 amounts, disclosed in this same note in the consolidated financial statements of the Group as at 31 December 2011, proved incorrect. The incorrect asumption had no effect on the amounts reported by the Group in the income statement or statement of financial position as at 31 December 2011. The Group uses the correct assumptions for the comparative amounts of 2011, disclosed in this note as at 31 December 2012.

Unguaranteed residual value at year end 2012 is nil (2011: nil).

## 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 2012, financial assets managed by the Group amounted to ISK 95 billion (2011: ISK 112 billion). Custody accounts amounted to ISK 1.368 billion (2011: ISK 1.093 billion).

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## 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 2012 were the following:

| Company | Ownership interest | Activity |
|---|---|---|
| Eignarhaldsfélag Landsbankans ehf. (Iceland) | 100% | Holding company |
| Horn fjárfestingarfélag hf. (Iceland) | 100% | Investment company |
| Landsvaki ehf. (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 |
| Landsbanki Vatnsafl ehf. (Iceland) | 100% | Holding company |
| Span ehf. (Iceland) | 100% | IT-services |
| Landsbanki Holdings UK plc. (United Kingdom) | 100% | Holding company |

LBI hf. has significant influence over the Bank, indirectly through its wholly owned subsidiary Landskil ehf., which holds 18.7% of the shares in the Bank. Landskil ehf. appoints one of the five members of the Board of Directors of the Bank and LBI hf. has also influence through its observers role in the Bank's Credit committee. Although these observers do not have rights to take part in the decision process during meetings of the Credit committee 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 committee of the Bank, LBI hf. meets the definition of related party. As of 1 January 2013 LBI hf. no longer has the right to attend meetings of the Bank's Credit committee.

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 related party 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 56.

#### (b) Transactions with other related parties

The deposits from LBI hf. amounted to ISK 43,807 million as at 31 December 2012 (2011: ISK 29,942 million). During the year 2012 the Bank recognised ISK 235 million from administrative services provided to LBI hf. based on a service level agreement (2011: ISK 324 million).

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## 41. Related party transactions (continued)

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:

| | 2012 | | 2011 | |
|---|---|---|---|---|
| **Loans in ISK million** | **Balance at 31 December** | **Maximum exposure** | **Balance at 31 December** | **Maximum exposure** |
| Key management personnel | 108 | 237 | 112 | 133 |
| Parties related to key management personnel | 176 | 333 | 247 | 299 |
| Associates | 44,544 | 72,677 | 48,136 | 84,971 |
| **Total** | **44,828** | **73,247** | **48,495** | **85,403** |

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

No 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.

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

| | 2012 | | 2011 | |
|---|---|---|---|---|
| **Deposits in ISK million** | **Balance at 31 December** | **Maximum exposure** | **Balance at 31 December** | **Maximum exposure** |
| Key management personnel | 112 | 168 | 124 | 194 |
| Parties related to key management personnel | 56 | 166 | 65 | 88 |
| Associates | 18,432 | 36,667 | 17,330 | 25,187 |
| **Total** | **18,600** | **37,001** | **17,519** | **25,469** |

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

| **Guarantees in ISK million** | **2012** | **2011** |
|---|---|---|
| Key management personnel | - | 4 |
| Associates | 507 | 501 |
| **Total** | **507** | **505** |

All the above transactions were made in the ordinary course of business and on substantially the same terms, including interest rates and collaterals, as those prevaling at the time for comparable transactions with third party counterparties.

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

| **Salary and benefits for the year 2012** | **Salary and benefits*** | **Defined contri-butions**** | **Termi-nation benefits** | **Total** |
|---|---|---|---|---|
| Gunnar Helgi Hálfdanarson, Chairman of the Board of the Bank | 8.1 | 0.6 | - | 8.7 |
| Sigríður Hrólfsdóttir, Vice-chairman of the Board of the Bank | 6.0 | 0.5 | - | 6.5 |
| Þórdís Ingadóttir, member of the Board of the Bank | 5.1 | 0.4 | - | 5.5 |
| Ólafur Helgi Ólafsson, member of the Board of the Bank | 5.1 | 0.4 | - | 5.5 |
| Andri Geir Arinbjarnarson, member of the Board of the Bank | 5.5 | 0.4 | - | 5.9 |
| Alternate directors of the Board of the Bank | 5.1 | 0.4 | - | 5.5 |
| Steinþór Pálsson, CEO of the Bank | 14.2 | 2.4 | - | 16.6 |
| 7 Managing Directors of the Bank's divisions | 134.6 | 25.5 | - | 160.1 |
| 2 former Managing Directors of the Bank | 41.6 | 8.0 | - | 49.6 |
| Other managing directors | 16.6 | 2.6 | - | 19.2 |
| **Total** | **241.9** | **41.2** | **0.0** | **283.1** |

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

**Includes both private and statutory contributions to independent pension funds without further obligation.

In 2012 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.

In addition to the salaries and related expenses of the CEO in the table above the Bank makes a provision at year end 2012 in the amount of ISK 47 million, due to possible corrections or retroactive adjustments of the CEO's salary and employment conditions for the years 2011 and 2012.

## 41. Related party transactions (continued)

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

| Salary and benefits for the year 2011 | Salary and benefits* | Defined contri-butions** | Termi-nation benefits*** | Total |
|---|---|---|---|---|
| Gunnar Helgi Hálfdanarson, Chairman of the Board of the Bank | 6.4 | 0.5 | - | 6.9 |
| Sigríður Hrólfsdóttir, Vice-chairman of the Board of the Bank | 5.1 | 0.4 | - | 5.5 |
| Guðríður Ólafsdóttir, member of the Board of the Bank | 1.6 | 0.1 | - | 1.7 |
| Þórdís Ingadóttir, member of the Board of the Bank | 4.1 | 0.3 | - | 4.4 |
| Ólafur Helgi Ólafsson, member of the Board of the Bank | 4.1 | 0.3 | - | 4.4 |
| Andri Geir Arinbjarnarson, alternate member of the Board of the Bank | 4.4 | 0.3 | - | 4.7 |
| Other alternate directors of the Board of the Bank | 3.5 | 0.3 | - | 3.8 |
| Steinþór Pálsson, CEO of the Bank | 13.9 | 2.3 | - | 16.2 |
| 8 Managing Directors of the Bank's divisions | 168.0 | 31.9 | - | 199.9 |
| Managing Directors of subsidiaries Vestia, Horn, Reginn, Landsvaki and SP fjármögnun | 77.3 | 9.6 | 24.0 | 110.9 |
| **Total** | **288.4** | **46.0** | **24.0** | **358.4** |

*Benefits are non-monetary benefits in the form of free use of cars owned by the Group.
**Includes both private and statutory contributions to independent pension funds without further obligation.
***Termination benefits payable in the year 2011 were fully recognised as an expense in the year 2010.

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.

### (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 2012. 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.

## 42. Events after the reporting period

The main event after the reporting period is the following:

In January 2013 a client of the Bank commenced litigation against the Bank claiming acknowledgement by the Court that he is not legally bound by a clause on consumer price index in a bond issued by himself to the Bank, alternatively that the Court confirms that the Bank is not entitled to revalue the principal amount of the bond on a monthly basis according to the consumer price index. Furthermore, the client claims confirmation by the Court that he is not legally bound by a clause in the same bond regarding the issuer's duty to pay a settlement fee. The client claims that the bond´s clauses are illegal according to the Securities Transaction Act No. 108/2007 and EU Directive No. 2004/39/EB. The Bank will submit its defence and it is foreseeable that the case will be heard before the District Court of Reykjavík in the spring of 2013.

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## 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 four interdependent activities: Capital Assessment, Risk Appetite/Capital Target, Capital Planning, and Reporting/Monitoring. 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.

Capital requirements are defined by two external bodies: the European Council (EU) and the Financial Supervisory Authority in Iceland (FME). The basis of the requirements of both bodies is the EU Capital Requirements Directive (CRD). The regulatory minimum capital requirement under Pillar I of the directive is 8% of risk weighted assets for credit risk, market risk and operational risk. The Capital Adequacy Requirement (CAD) is reviewed by the FME in the Supervisory Review and Evaluation Process (SREP).

The Group uses the standardised approach in measuring Pillar I risks. Risk-weighted assets (RWA) for credit risk, the single largest risk type, amounted to 77.3% of total RWA. The Internal Capital Adequacy Assessment Process (ICAAP) under Pillar II is the Group's calculation of its solvency need (as percentage of RWA) and is based on economic capital calculations, stress tests and result of the Supervisory Review and Evaluation Process (SREP). The economic capital is estimated at 15.5% for year end 2012. In the latest SREP process, based on year end 2011, the FME determined the Capital Adequacy Ratio to be at 19.5%, mainly because of uncertainty regarding currency loans. This is 11.5% additional to the requirement of the EU directive.

The FME requires the Group to maintain a minimum core Tier 1 capital ratio of 12% unless revised by FME. The previous Capital Adequacy Ratio (CAD ratio) requirement of the FME for the Group was increased from 16% to 19.5% in the fourth quarter of 2012 (estimation based on year end 2011) and is now determined by the Group's calculation of its solvency need (ICAAP report) and SREP by the FME which is performed each year.

### 44. Capital base and capital adequacy ratio

The Group's equity at 31 December 2012 amounted to ISK 225,166 million (31.12.2011: ISK 200,244 million), equivalent to 20.8% (31.12.2011: 17.6%) of total assets, according to the condensed consolidated statement of financial position. The Capital Adequacy Ratio, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 25.1% at 31 December 2012 (31.12.2011: 21.4%). Under the Act the minimum requirement for this ratio is 8%.

| **Capital base** | **31.12.2012** | **31.12.2011** |
|---|---|---|
| Share capital | 24,000 | 24,000 |
| Share premium | 123,898 | 123,898 |
| Statutory reserve | 5,053 | 3,781 |
| Retained earnings | 72,120 | 47,952 |
| Non-controlling interests | 95 | 613 |
| **Total equity** | **225,166** | **200,244** |
| Intangible assets | (541) | (681) |
| Deferred tax assets | (48) | (3,003) |
| **Tier 1 capital** | **224,577** | **196,560** |
| Deduction from original and additional own funds | (3,815) | (4,531) |
| **Capital base** | **220,762** | **192,029** |
| | | |
| **Risk-weighted assets (RWA)** | | |
| Credit risk | 679,516 | 696,402 |
| Market risk | 98,486 | 120,557 |
| Operational risk | 101,393 | 81,500 |
| **Total Risk-weighted assets** | **879,395** | **898,459** |
| | | |
| Tier 1 capital ratio | 25.5% | 21.9% |
| Capital adequacy ratio (CAD) | 25.1% | 21.4% |

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## Economic Capital

### 45. Economic Capital framework

Economic Capital (EC) is a risk measure which is applied to all material risks. It captures unexpected losses and reduction in value or income for which the Bank needs to hold capital to avoid insolvency. It arises from the unexpected nature of losses as distinct from expected losses. EC is defined as the difference between unexpected losses and expected losses, where unexpected loss is defined as the 99.9% Value-at-Risk, with a one year time horizon.

The purpose of the EC framework is to enable the Bank to assess the amount of capital it requires to cover the economic effects of risk taking activities as well as to compare different risk types using a common "risk currency".

The objective of the EC framework is to measure unexpected losses as well as to decompose EC on various levels to enable capital allocation, limit setting, pricing of products, risk adjusted performance measurement and value based management.

The framework covers the following risk types: credit risk; market risk; operational risk; concentration risk, interest rate risk in the non-trading book; legal risk and business risk.

The following summarises how the Group calculates its Economic Capital for these risks.

Credit risk:
The credit risk Economic Capital model is the asymptotic single risk factor (ASRF) model from the Basel II internal rating based (IRB) approach's risk weight formula, i.e. the EC equals the capital requirements of the IRB approach in the capital requirements directive. The main input to the model are the risk parameters probability of default (PD), loss given default (LGD) and exposure at default (EAD).

Market risk:
Market risk EC for interest rate and equity risks is calculated using the standardised measurement method of the Basel framework, i.e EC equals the Bank´s capital requirements for interest rate and equity risks.

Currency risk:
For FX positions a VaR-model is used to calculate Economic Capital. 1-day 99% VaR as well as stressed VaR (SVaR) are calculated and scaled to one-year 99% VaR in accordance with the Basel framework. Stressed VaR is calculated from the worst case of the previous 250 trading days. Economic Capital for FX-risk equals the sum of the two one-year 99% VaR measures.

Concentration risk:
EC for single name concentration is calculated by adjusting for the granularity and inhomogenities in the portfolio. This is necessary as the credit risk EC-model assumes that the portfolio is infinitely large and homogenous hence the single name concentration EC is given as an add-on.

An internal model is used to measure the additional EC for credit risk related to industry concentrations in the loan portfolio, i.e. a concentration add-on. EC is given by the increase in credit risk EC when a correlation adjusted for the concentration in the portfolio is used.

Interest rate risk in the banking book:
Interest rate risk in the banking book EC is equal to the loss of economic value resulting from a simultaneous parallel shift in the relevant interest rate curves.

Operational risk:
Economic Capital for Operational risk is calculated using the basic indicator approach, hence it equals the Bank´s capital requirement.

Business risk:
Economic Capital for Business risk is calculated using an internal model, which is based on the volatility of the Bank's income, before profit or losses due to any other material risk.

Legal and regulatory risk:
Economic Capital for legal and regulatory risk is calculated by adding the potential loss of ongoing disputes.

### 46. Economic Capital by risk type

The Economic Capital decreased slightly during 2012 mainly due to improved quality of the loan portfolio and lower assessment of Economic Capital for Creditor concentration risk. Legal and regulatory risk has increased as well as Interest rate risk but the Group has revised its methodology for interest rate sensitivity measurements for non-trading portfolios by applying more severe interest rate shocks to the relevant yield curves taking historical interest rate volatility into account. Credit risk is the largest source of risk confronting the Bank and in the year 2012 the EC for this risk type decreased slightly. The reduction is, as mentioned above, attributed to improved quality of the loan portfolio.

| Economic Capital ISK Million | 2012 | 2011 |
|---|---|---|
| Credit risk - Loans to customers and credit institutions | 68,764 | 69,296 |
| Credit risk - Other assets | 5,041 | 6,834 |
| Market risk | 5,865 | 7,399 |
| Currency risk | 3,676 | 2,443 |
| Operational risk | 8,111 | 6,520 |
| Single name concentration risk | 8,099 | 21,603 |
| Industry concentration risk | 2,710 | 2,466 |
| Interest rate risk | 10,688 | 5,055 |
| Business risk | 4,056 | 3,260 |
| Legal and regulatory risk | 18,913 | 12,800 |
| **Total** | **135,923** | **137,676** |
| EC/RWA | 15.5% | 15.3% |

| | Weighted average | | | |
|---|---|---|---|---|
| **Credit risk at 31 December 2012** | **Probability of default (PD)** | **Loss given default (LGD)** | **Exposure at default (EAD)** | **Economic Capital (EC)** |
| Financial institutions | 1.5% | 45.0% | 58,357 | 2,716 |
| Public entities | 1.2% | 44.9% | 26,277 | 1,687 |
| Individuals | 2.7% | 33.2% | 214,516 | 8,078 |
| Corporates | 6.0% | 44.0% | 527,410 | 56,283 |
| **Total** | **4.6%** | **41.3%** | **826,560** | **68,764** |

| | Weighted average | | | |
|---|---|---|---|---|
| **Credit risk at 31 December 2011** | **Probability of default (PD)** | **Loss given default (LGD)** | **Exposure at default (EAD)** | **Economic Capital (EC)** |
| Financial institutions | 3.1% | 45.0% | 95,656 | 2,838 |
| Public entities | 0.9% | 44.8% | 19,725 | 1,052 |
| Individuals | 2.8% | 32.3% | 173,013 | 7,081 |
| Corporates | 8.8% | 43.8% | 493,207 | 58,325 |
| **Total** | **6.6%** | **41.4%** | **781,601** | **69,296** |

## Risk management

### 47. Risk management structure

The Group’s risk management governance structure as at year end 2012 is as follows:

| | | | | | |
|---|---|---|---|---|---|
| **Supervision by the Board of Directors** | **Board of Directors**<br>Internal Audit, Audit and Risk Committee, Governance Committee | | | | |
| **Key risk management bodies and committees** | **The CEO**<br>Credit Committee<br>Risk and Finance Committee<br>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 of the framework and risk appetite through the corporate governance structure and committees. The CEO has established and is a member of the Credit Committee, the Risk and Finance Committee and the Executive Management Committee.

### 47. Risk management structure (continued)

The Credit Committee deals with credit risk, both credit limits for individual customers as well as credit risk policy issues, while the Risk and Finance Committee covers primarily market risk, liquidity risk and legal risk. The Risk and Finance Committee monitors all the Group's risks, 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. The Executive Management Committee 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 committee.

The Bank's Risk Management Division is responsible for the functioning of 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 Risk Management division has six units.

• The Credit Management Unit is responsible for risk assessment and secondary voting on credit applications from 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 authorisation of the Risk Management Division is referred to the Bank's Credit Committee.

• The Credit Risk Monitoring Unit is responsible for monitoring credit risk within the Bank's credit portfolio. This is done by operating a credit monitoring system. The Credit Risk Monitoring unit is also responsible for the portfolio valuation methodology as for the operation of the Bank's write off process. In addition the unit works with other units on impairment analysis.

• The Market risk Unit is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the banking book for the Group. The Market risk unit is also responsible for monitoring all derivatives trading the Group enters into, both for hedging and trading purposes. Market Risk monitoring also includes FX balance monitoring for the Group as well as providing limit monitoring for Pension funds that are managed within the Group. The Market risk unit is also responsible for comprehensive risk reporting to various departments and committees.

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

• The Models and Analysis Unit is responsible for providing, developing and maintaining 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, economic capital and risk appetite reporting within the Bank as well as reporting to supervisory authorities.

• 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.

The Bank's Compliance Department ensures that the Group adheres to its own rules on securities trading and insider trading and that the Group's operations comply with Act No. 108/2007, on Securities Transactions, Act No. 67/2006 on Actions to Combat Money Laundering and Terrorist Financing, and other relevant legislation and regulations. The Compliance 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 Internal Capital Adequacy Assessment process (ICAAP), 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 appetite

During 2012 the Group's risk appetite has been reviewed, revised and implemented for 2013. 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 Bank's 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.

### 48. Risk appetite (continued)

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 and and their potential interrelationship. 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 Bank's 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.

### 49. Risk management process

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 ensure 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 the 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.

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

The Group is exposed to the following material risks which arise from financial instruments:
· Credit risk
· Market risk
    -Currency risk
    -Interest rate risk
    -Other market risk
· Liquidity risk
· Operational risk
The Group also manages other relevant risk, such as business, legal and compliance risk.

The above material risks are addressed in the following notes.

## Credit risk

### 50. Credit risk identification

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

### 51. Credit risk assessment

Credit risk is measured in three main dimensions: the probability of default (PD); the loss given default (LGD) and the exposure. For the purpose of measuring PD the Group has developed an internal rating system, including a number of internally developed rating models. The objectives of the rating system are to provide a meaningful assessment of obligor characteristics; a meaningful differentiation of credit quality; and accurate and consistent quantitative estimates of default risk, i.e. probabilities of default. Internal ratings and associated PD play an essential role in the risk management and decision-making process, and in the credit approval and corporate governance functions.

The rating system has an obligor ‘rating scale’ which reflects exclusively quantification of the risk of obligor default, i.e. credit quality. The obligor rating scale has 10 rating grades for non-defaulted obligors going from ‘1’ to ‘10’, ‘10’ indicating the highest credit quality, and the grade ‘0’ for defaulted obligors. The rating assignment is supported by rating models, which takes information such as industry classification, financial accounts and payment behaviour into account.

The rating assignment and approval is an integrated part of the credit approval process and assignment shall be updated at least annually or when material information on the obligor or exposure becomes available, whichever is earlier.

### 51. Credit risk assessment (continued)

LGD is measured using the models defined in the Basel framework for the purpose of Economic Capital calculations. In addition, during 2012 the Group implemented in the business processes an internal LGD model, which takes into account more types of collateral and is more sensitive to the collateralisation level than the forementioned Basel model.

The exposure is calculated using the credit conversion factors of the Basel framework.

### 52. Credit risk control and monitoring

The Group monitors exposures to identify signs of weakness in customer operations affecting their earnings and liquidity at the earliest possible time.

To monitor customers the Group uses, supplemental to using ratings, a credit monitoring classification of four credit risk groups (green, yellow, orange and red). The colour classification is 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 instalments 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 restructuring or postponement of instalments.

• Red customers are those that are under the supervision of the Corporate Solutions 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 together with the business units responsible for the verification of colour for the customer and transfer of customers from the business units to Corporate Solutions if necessary.

External ratings were used where applicable to assist in managing the credit risk exposure of bonds. Otherwise the Group used fair value estimates base 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.

### 53. 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, the credit units within the Risk Management and the business units. 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 authorisation levels are defined based on size of units, types of customers and lending experience of credit officers. Credit decisions exceeding authorisation levels of business units are subject to confirmation 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 Board of Directors which has the highest credit authorisation within the Bank.

### 54. Credit risk mitigation

Mitigating risks in the credit portfolio is a key element of the Group's credit policy as well as being an inherent part of the credit decision process. Securing loans with collateral is the main method of mitigating credit risk whereas for many loan products, collateral is required by legislation, as in the mortgage finance market, or is standard market practice.

The most important types of collaterals are real property and financial assets (shares or bonds).

### 54. Credit risk mitigation (continued)

The amount and type of collateral required depends on an assessment of the credit risk associated with the counterparty. Valuation parameters and the acceptability of different types of collateral are defined in the Groups's lending rules. 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.

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 estimates 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 listed securities, haircuts are calculated with an internal model based on variables, such as price volatility and marketability.

The Group monitors the market value of mark to market collaterals and may require additional collateral in accordance with underlying loan agreements.

The Group is finalising the implementation of 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 International Swaps and Derivatives Association (ISDA) master agreeements with financial institutions and similar general agreements with other derivatives counterparties of the Bank.  Such agreements include, among other things, netting and set-off arrangements.

The Bank makes appropriate collateral and margin requirments  for all derivative contracts the Group enters into.  Collateral management and monitoring is performed daily and derivative contracts with clients are usually fully hedged.

The Group's supervision system monitors derivatives exposures and collateral value intraday, it issues margin calls and manages netting and set-off agreements.

### 55. Loan impairment

Group policy requires that individual financial assets above materiality thresholds be reviewed at least quarterly, and more frequently when circumstances require. 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 is reflected in loan impairment, or net adjustments to loans and advances, as the expected cash flow of customers has changed.

The Group has significantly reduced granting loans in foreign currency unless the customer's income is in the same currency or a comparable currency.

## 56. Maximum exposure to credit risk and concentration by industry sectors

The following tables shows the Group's maximum credit risk exposure at 31 December 2012 and 2011. 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 Group uses the ISAT 08 industry classification for corporate customers.

| | | | | Corporations | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2012** | **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 | - | 25,898 | - | - | - | - | - | - | - | - | - | | - | **25,898** |
| Bonds and debt instruments | 9,528 | 216,935 | - | - | 3 | - | - | 397 | 352 | - | - | | 993 | **228,208** |
| Derivative instruments | 1,039 | - | - | - | - | - | - | - | - | - | - | | 4 | **1,043** |
| Loans and advances to financial institutions | 64,349 | - | - | - | - | - | - | - | - | - | - | | - | **64,349** |
| Loans and advances to customers | - | 11,576 | 195,047 | 142,952 | 104,928 | 52,700 | 42,019 | 60,009 | 25,665 | 10,199 | 19,413 | | 1,579 | **666,087** |
| Other financial assets | 8,106 | 276 | 600 | 11 | 300 | 587 | - | - | 253 | - | 2 | | 346 | **10,481** |
| **Total on-balance sheet exposure** | **83,022** | **254,685** | **195,647** | **142,963** | **105,231** | **53,287** | **42,019** | **60,406** | **26,270** | **10,199** | **19,415** | | **2,922** | **996,066** |
| **Off-balance sheet exposure** | **4,054** | **14,215** | **28,146** | **14,374** | **30,797** | **11,465** | **8,612** | **1,147** | **2,361** | **1,049** | **2,496** | | **46** | **118,762** |
| Financial guarantees and underwriting commitments | - | 95 | 463 | 1,731 | 23,149 | 2,123 | 1,685 | 208 | 584 | 39 | 552 | | 35 | 30,664 |
| Undrawn loan commitments | 1,500 | 9,022 | 22 | 10,592 | 5,628 | 2,122 | 1,948 | 278 | 194 | 701 | 901 | | - | 32,908 |
| Undrawn overdraft/credit card facilities | 2,554 | 5,098 | 27,661 | 2,051 | 2,020 | 7,220 | 4,979 | 661 | 1,583 | 309 | 1,043 | | 11 | 55,190 |
| **Maximum exposure to credit risk** | **87,076** | **268,900** | **223,793** | **157,337** | **136,028** | **64,752** | **50,631** | **61,553** | **28,631** | **11,248** | **21,911** | | **2,968** | **1,114,828** |
| Percentage of carrying amount | 7.8% | 24.1% | 20.1% | 14.1% | 12.2% | 5.8% | 4.5% | 5.5% | 2.6% | 1.0% | 2.0% | | 0.3% | 100% |

* 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.

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

| | | | | 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 | 173,222 | 135,397 | 101,958 | 66,120 | 42,401 | 48,622 | 28,008 | 8,506 | 20,168 | 2,589 | **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** | **173,222** | **135,451** | **101,960** | **66,682** | **42,401** | **51,471** | **28,316** | **8,506** | **20,172** | **2,987** | **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** | **204,880** | **146,723** | **110,152** | **75,268** | **53,749** | **57,937** | **31,192** | **10,656** | **22,798** | **4,143** | **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.

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### 57. Collaterals and Loan-to-value by Industry sectors

The loan-to-value (LTV) ratio expresses the maximum exposure of credit risk (carrying amount of loans and off-balance sheet items) as a percentage of the total appraised value of collateral. Loan to value is one of the key risk factors that is assessed when qualifying borrowers for a loan. The risk of default is always at the forefront of lending decisions, and the likelihood of a lender absorbing a loss in the foreclosure process increases as the collateral value decreases. A high LTV indicates that there is less cushion to protect against pricefalls or increases in the loan if repayments are not made and interest is added to the outstanding balance.

| | LTV Ratio - Fully collateralised | | | | | LTV Ratio - Partially collateralised | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2012** | **0% - 25%** | **25% - 50%** | **50% - 75%** | **75% - 100%** | **Total** | **>100%** | **Collateral value** | **Without Collaterals*** | **Allowance for impairment** | **Maximum exposure to credit** |
| Financial institutions | - | - | - | - | - | - | - | 68,404 | - | 68,404 |
| Public entities | 25 | 43 | 172 | 104 | 344 | 6,002 | 1,142 | 19,552 | 107 | 25,791 |
| Individuals | 6,621 | 11,206 | 14,577 | 18,473 | 50,877 | 100,197 | 64,967 | 84,679 | 12,560 | 223,193 |
| Corporations | | | | | | | | | | |
| Fisheries | 1,091 | 4,765 | 24,202 | 20,277 | 50,335 | 90,952 | 58,291 | 22,564 | 6,525 | 157,326 |
| Construction and real estate companies | 320 | 1,833 | 3,167 | 9,321 | 14,641 | 121,949 | 49,980 | 6,765 | 7,630 | 135,725 |
| Holding companies | 402 | 163 | 1,043 | 1,950 | 3,558 | 49,780 | 32,115 | 14,044 | 6,226 | 61,156 |
| Retail | 159 | 641 | 1,281 | 1,065 | 3,146 | 42,039 | 17,042 | 10,977 | 5,530 | 50,632 |
| Services | 803 | 811 | 10,719 | 1,581 | 13,914 | 34,793 | 14,160 | 18,673 | 3,217 | 64,163 |
| Information, technology and communication | 25 | 35 | 65 | 29 | 154 | 20,727 | 6,396 | 1,383 | 357 | 21,907 |
| Manufacturing | 72 | 278 | 729 | 1,010 | 2,089 | 19,283 | 10,786 | 7,792 | 1,138 | 28,026 |
| Agriculture | 176 | 119 | 262 | 64 | 621 | 10,205 | 3,910 | 970 | 547 | 11,249 |
| Other | 3 | - | 77 | - | 80 | 41 | 26 | 1,696 | 193 | 1,624 |
| **Total** | **9,697** | **19,895** | **56,294** | **53,874** | **139,759** | **495,968** | **258,815** | **257,499** | **44,030** | **849,196** |
| **At 31 December 2011** | | | | | | | | | | |
| Financial institutions | - | - | - | - | - | - | - | 100,133 | - | 100,133 |
| Public entities | 29 | 43 | 105 | 214 | 391 | 2,135 | 1,041 | 17,270 | 74 | 19,722 |
| Individuals | 9,466 | 13,732 | 25,297 | 21,487 | 69,982 | 46,169 | 26,231 | 96,463 | 7,732 | 204,882 |
| Corporations | | | | | | | | | | |
| Fisheries | 919 | 10,067 | 34,247 | 16,160 | 61,393 | 73,407 | 26,500 | 16,843 | 4,975 | 146,668 |
| Construction and real estate companies | 920 | 1,008 | 3,421 | 9,302 | 14,651 | 93,926 | 49,199 | 7,526 | 5,955 | 110,148 |
| Holding companies | 38 | 167 | 278 | 129 | 612 | 51,469 | 13,682 | 6,550 | 3,544 | 55,087 |
| Retail | 1,270 | 889 | 1,760 | 1,908 | 5,827 | 46,687 | 13,270 | 3,512 | 2,277 | 53,749 |
| Services | 571 | 1,476 | 1,856 | 1,174 | 5,077 | 32,967 | 12,202 | 38,809 | 2,146 | 74,707 |
| Information, technology and communication | 120 | 70 | 16 | 29 | 235 | 19,646 | 3,961 | 3,071 | 158 | 22,794 |
| Manufacturing | 60 | 751 | 592 | 2,209 | 3,612 | 12,572 | 4,554 | 15,092 | 426 | 30,850 |
| Agriculture | 100 | 302 | 205 | 227 | 834 | 8,942 | 2,322 | 1,835 | 957 | 10,654 |
| Other | 1 | - | - | 70 | 71 | 27 | 18 | 3,823 | 177 | 3,744 |
| **Total** | **13,494** | **28,505** | **67,777** | **52,909** | **162,685** | **387,947** | **152,980** | **310,927** | **28,421** | **833,138** |

*Credit card loans and overdraft on debit cards are assumed to be without collateral. If LTV is less than 100% the loan is considered fully secured. If LTV is greater than 100% the loan is partially collateralised and the respective collateral value is shown in the table.

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## 58. Loans and advances by geographical area

| At 31 December 2012 | Domestic | Foreign | Carrying amount |
|---|---|---|---|
| Loans and advances to financial institutions | 8,358 | 55,991 | 64,349 |
| Loans and advances to customers | 622,800 | 43,288 | 666,087 |
| **Total loans and advances to customers** | **631,158** | **99,279** | **730,436** |

| At 31 December 2011 | Domestic | Foreign | Carrying amount |
|---|---|---|---|
| Loans and advances to financial institutions | 6,242 | 93,891 | 100,133 |
| Loans and advances to customers | 589,666 | 49,465 | 639,130 |
| **Total loans and advances to customers** | **595,908** | **143,356** | **739,263** |

## 59. Collateral types

The following tables shows the collaterals used to mitigate credit risk.

| At 31 December 2012 | Real Estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1,575 | - | 32 | - | 38 | 1,645 |
| Individuals | 152,374 | 23 | 2,339 | 2,438 | 88 | 157,262 |
| Corporates | | | | | | - |
| Fisheries | 5,395 | 112,632 | 136 | 2,564 | 5,455 | 126,182 |
| Construction and real estate companies | 77,958 | - | 1,162 | 340 | 1,559 | 81,019 |
| Holding companies | 4,751 | - | 210 | 27,304 | 3,627 | 35,892 |
| Retail | 11,515 | - | 219 | 627 | 10,514 | 22,875 |
| Services | 30,372 | 430 | 866 | 2,678 | 1,982 | 36,328 |
| ITC | 756 | 8 | 125 | 1,843 | 4,357 | 7,089 |
| Manufacturing | 7,179 | - | 385 | 5,408 | 1,370 | 14,342 |
| Agriculture | 3,203 | - | 4 | - | 2,671 | 5,878 |
| Other | 261 | - | 1 | - | - | 262 |
| **Total** | **295,339** | **113,093** | **5,479** | **43,202** | **31,661** | **488,774** |

| At 31 December 2011 | Real Estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1,627 | - | 271 | - | 38 | 1,936 |
| Individuals | 141,471 | - | 2,503 | 1,001 | 60 | 145,035 |
| Corporates | | | | | | - |
| Fisheries | 5,877 | 98,933 | 1,386 | 3,514 | 5,179 | 114,889 |
| Construction and real estate companies | 92,070 | 91 | 1,780 | 231 | 1,432 | 95,604 |
| Holding companies | 7,028 | - | 3,469 | 15,263 | 2,312 | 28,072 |
| Retail | 12,440 | - | 1,536 | 56 | 7,689 | 21,721 |
| Services | 22,995 | 63 | 1,134 | 810 | 1,311 | 26,313 |
| ITC | 715 | - | 144 | 1 | 2,368 | 3,228 |
| Manufacturing | 7,263 | - | 282 | 608 | 944 | 9,097 |
| Agriculture | 4,015 | - | 23 | - | 27 | 4,065 |
| Other | 731 | - | 31 | 239 | 1,232 | 2,233 |
| **Total** | **296,232** | **99,087** | **12,559** | **21,723** | **22,592** | **452,194** |

*Other includes collaterals like financial claims, invoices, liquid assets, vehicles, machines, aircrafts and inventories.

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### 60. Loans and advances credit monitoring

The following tables shows the credit risk monitoring split on colour classification. Futher details on the credit risk monitoring and color classification can be seen in note 52, Credit risk control and monitoring.

| Industry sectors as at 31 December 2012 | Green | Yellow | Orange | Red | Carrying amount 31.12.2012 |
|---|---|---|---|---|---|
| Financial institutions | 64,349 | - | - | - | 64,349 |
| Public entities | 10,849 | 571 | 152 | 4 | 11,576 |
| Individuals | 149,615 | 9,641 | 19,010 | 16,781 | 195,047 |
| Corporations | | | | | |
| Fisheries | 102,319 | 29,130 | 3,006 | 8,497 | 142,952 |
| Construction and real estate companies | 55,038 | 16,190 | 18,318 | 15,382 | 104,928 |
| Holding companies | 32,668 | 10,867 | 8,028 | 8,446 | 60,009 |
| Retail | 18,643 | 16,075 | 2,470 | 4,831 | 42,019 |
| Services | 34,944 | 5,389 | 6,096 | 6,271 | 52,700 |
| Information, technology and communication | 18,853 | 192 | 202 | 166 | 19,413 |
| Manufacturing | 18,037 | 3,044 | 1,505 | 3,079 | 25,665 |
| Agriculture | 8,624 | 952 | 187 | 436 | 10,199 |
| Other | 346 | 657 | 471 | 105 | 1,579 |
| **Total** | **514,285** | **92,708** | **59,445** | **63,998** | **730,436** |

| Industry sectors as at 31 December 2011 | Green | Yellow | Orange | Red | Carrying amount 31.12.2011 |
|---|---|---|---|---|---|
| Financial institutions | 99,972 | - | 17 | 144 | 100,133 |
| Public entities | 8,342 | 539 | 1,057 | 2,201 | 12,139 |
| Individuals | 91,241 | 22,747 | 28,612 | 30,622 | 173,222 |
| Corporations | | | | | |
| Fisheries | 78,560 | 20,644 | 10,405 | 25,788 | 135,397 |
| Construction and real estate companies | 40,096 | 10,504 | 8,609 | 42,749 | 101,958 |
| Holding companies | 12,416 | 10,525 | 1,933 | 23,748 | 48,622 |
| Retail | 17,013 | 6,692 | 475 | 18,221 | 42,401 |
| Services | 40,196 | 1,833 | 10,238 | 13,853 | 66,120 |
| Information, technology and communication | 19,996 | 68 | 45 | 59 | 20,168 |
| Manufacturing | 18,606 | 2,328 | 478 | 6,596 | 28,008 |
| Agriculture | 7,752 | 271 | 34 | 449 | 8,506 |
| Other | 1,118 | 1,243 | 31 | 197 | 2,589 |
| **Total** | **435,308** | **77,394** | **61,934** | **164,627** | **739,263** |

### 61. Credit quality of financial assets

| | Gross carrying amount | | | | | |
|---|---|---|---|---|---|---|
| **At 31 December 2012** | 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 | 25,898 | - | - | 25,898 | - | 25,898 |
| Bonds and debt instruments | 219,009 | 9,199 | - | 228,208 | - | 228,208 |
| Derivative instruments | 1,043 | - | - | 1,043 | - | 1,043 |
| Loans and advances to financial institutions | 64,349 | - | - | 64,349 | - | 64,349 |
| Loans and advances to customers | 450,885 | 60,078 | 199,154 | 710,117 | (44,030) | 666,087 |
| Other financial assets | 10,481 | - | - | 10,481 | - | 10,481 |
| **Total** | **771,665** | **69,277** | **199,154** | **1,040,096** | **(44,030)** | **996,066** |
| | | | | | | |
| **At 31 December 2011** | | | | | | |
| 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** |

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

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## 62. Loans and advances neither past due nor individually impaired

The following tables shows the credit quality, measured by rating grade, of Loans and advances neither past due nor individually impaired. Further details on rating grades can be seen in note 51, Credit risk assessment.

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| **At 31 December 2012** | **10-7** | **6-4** | **3-1** | **0*** | **Unrated** | **Total** |
| Financial institutions | 64,349 | - | - | - | - | 64,349 |
| Public entities | 2,357 | 73 | 4,866 | 10 | 88 | 7,394 |
| Individuals | 11,266 | 21,276 | 97,272 | 3,968 | 5,987 | 139,769 |
| Corporations | | | | | | |
| Fisheries | 391 | 31,227 | 47,886 | 3,442 | 19 | 82,965 |
| Construction and real estate companies | - | 41,960 | 20,039 | 7,129 | 248 | 69,376 |
| Retail | - | 23,468 | 13,203 | 1,174 | 477 | 38,322 |
| Holding companies | - | 26,667 | 2,775 | 223 | 248 | 29,913 |
| Services | 10,884 | 18,201 | 11,454 | 1,131 | 488 | 42,158 |
| ITC | - | 239 | 13,724 | 30 | 26 | 14,019 |
| Agriculture | 54 | 4,872 | 16,337 | 230 | 154 | 21,647 |
| Manufacturing | 2 | 914 | 3,138 | 72 | 30 | 4,156 |
| Other | - | 534 | 3 | - | 630 | 1,167 |
| **Total** | **89,303** | **169,431** | **230,697** | **17,409** | **8,395** | **515,235** |

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| **At 31 December 2011** | **10-7** | **6-4** | **3-1** | **0*** | **Unrated** | **Total** |
| Financial institutions | 100,133 | - | - | - | - | 100,133 |
| Public entities | 2,761 | 86 | 5,699 | 12 | 103 | 8,661 |
| Individuals | 7,347 | 13,874 | 63,433 | 2,587 | 3,904 | 91,145 |
| Corporations | | | | | | |
| Fisheries | 486 | 38,787 | 59,480 | 4,276 | 23 | 103,052 |
| Construction and real estate companies | - | 40,895 | 19,530 | 6,948 | 241 | 67,614 |
| Retail | - | 25,187 | 14,171 | 1,260 | 512 | 41,130 |
| Holding companies | - | 20,566 | 2,140 | 172 | 191 | 23,069 |
| Services | 13,370 | 22,360 | 14,070 | 1,389 | 599 | 51,788 |
| ITC | - | 304 | 17,408 | 38 | 33 | 17,783 |
| Agriculture | 64 | 5,716 | 19,169 | 270 | 181 | 25,400 |
| Manufacturing | 3 | 1,420 | 4,874 | 109 | 46 | 6,452 |
| Other | - | 489 | 3 | - | 576 | 1,068 |
| **Total** | **124,164** | **169,684** | **219,977** | **17,061** | **6,409** | **537,295** |

*Due to the accounting policies, loans and advances acquired at deep discount are not impaired even though the Group considers the obligor likely not to meet its obligations. Hence such loans can be defaulted but neither past due nor individually impaired.

## 63. 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 2012** | **Past due 0 - 5 days** | **Past due 6-30 days** | **Past due 31 - 60 days** | **Past due 61 - 90 days** | **Past due over 90 days** | **Gross carrying amount** |
|---|---|---|---|---|---|---|
| Public entities | - | 2 | 1 | - | 19 | 22 |
| Individuals | 115 | 7,545 | 3,156 | 1,487 | 11,450 | 23,753 |
| Corporates | 1,052 | 4,570 | 2,134 | 1,262 | 27,285 | 36,303 |
| **Total** | **1,167** | **12,117** | **5,291** | **2,749** | **38,754** | **60,078** |
| | | | | | | |
| **At 31 December 2011** | | | | | | |
| Financial institutions | - | 1 | 7 | 8 | 144 | 161 |
| Public entities | - | 18 | 2 | 102 | 65 | 188 |
| Individuals | 3,205 | 7,810 | 4,523 | 2,725 | 24,655 | 42,918 |
| Corporates | 3,009 | 8,971 | 7,301 | 4,813 | 50,064 | 74,158 |
| **Total** | **6,214** | **16,800** | **11,833** | **7,648** | **74,928** | **117,425** |

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## 64. Loans and advances by industry sectors

| At 31 December 2012 | Gross carrying amount | Not individually impaired | Individually impaired: Of which performing | Individually impaired: Individual allowance | Individually impaired: Of which non-performing* | Individually impaired: Individual allowance | Collective allowance | Carrying amont |
|---|---|---|---|---|---|---|---|---|
| Financial institutions | 64,349 | 64,349 | - | - | - | - | - | 64,349 |
| Public entities | 11,682 | 7,750 | 3,717 | 51 | 108 | 11 | 44 | 11,576 |
| Individuals | 207,608 | 165,035 | 22,436 | 3,549 | 7,577 | 6,379 | 2,632 | 195,047 |
| Corporates | | | | | | | | |
| Fisheries | 149,477 | 86,823 | 54,380 | 2,448 | 1,749 | 1,496 | 2,582 | 142,952 |
| Construction and real estate companies | 112,558 | 78,437 | 22,988 | 1,926 | 3,503 | 1,869 | 3,835 | 104,928 |
| Holding companies | 66,235 | 37,378 | 22,050 | 564 | 582 | 2,575 | 3,087 | 60,009 |
| Retail | 47,549 | 32,217 | 8,763 | 2,376 | 1,039 | 1,634 | 1,520 | 42,019 |
| Services | 55,917 | 44,958 | 6,713 | 1,323 | 1,028 | 908 | 986 | 52,700 |
| ITC | 19,770 | 14,076 | 5,287 | 186 | 50 | 46 | 126 | 19,413 |
| Manufacturing | 26,802 | 22,461 | 2,889 | 458 | 315 | 334 | 346 | 25,665 |
| Agriculture | 10,747 | 4,850 | 5,093 | 127 | 256 | 173 | 248 | 10,199 |
| Other | 1,772 | 1,471 | - | - | 110 | 90 | 101 | 1,579 |
| **Total** | **774,466** | **559,805** | **154,316** | **13,008** | **16,317** | **15,515** | **15,507** | **730,436** |

| At 31 December 2011 | Gross carrying amount | Not individually impaired | Individually impaired: Of which performing | Individually impaired: Individual allowance | Individually impaired: Of which non-performing* | Individually impaired: Individual allowance | Collective allowance | Carrying amont |
|---|---|---|---|---|---|---|---|---|
| Financial institutions | 100,133 | 100,133 | - | - | - | - | - | 100,133 |
| Public entities | 12,143 | 8,607 | 3,457 | 24 | - | 0 | 50 | 12,139 |
| Individuals | 186,033 | 135,840 | 21,612 | 3,354 | 8,039 | 4,025 | 353 | 173,222 |
| Corporates | | | | | | | | |
| Fisheries | 137,878 | 115,326 | 12,729 | 1,876 | 2,367 | 821 | 2,278 | 135,397 |
| Construction and real estate companies | 107,013 | 74,563 | 19,358 | 1,090 | 2,082 | 1,888 | 2,977 | 101,958 |
| Holding companies | 51,112 | 40,406 | 4,317 | 1,160 | 355 | 1,598 | 786 | 48,622 |
| Retail | 44,443 | 34,270 | 3,882 | 295 | 1,972 | 1,032 | 950 | 42,401 |
| Services | 68,301 | 58,225 | 4,450 | 305 | 1,300 | 1,097 | 744 | 66,120 |
| ITC | 20,261 | 18,161 | 1,770 | 3 | 79 | 61 | 94 | 20,168 |
| Manufacturing | 28,709 | 26,172 | 1,201 | 137 | 210 | 253 | 36 | 28,008 |
| Agriculture | 8,834 | 6,031 | 1,470 | 477 | 48 | 41 | 439 | 8,506 |
| Other | 2,823 | 2,216 | - | - | 195 | 159 | 17 | 2,589 |
| **Total** | **767,683** | **619,950** | **74,246** | **8,721** | **16,647** | **10,975** | **8,724** | **739,263** |

*Non-performing past due more than 90 days

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## 65. Allowance for impairment on loans and advances to financial institutions and customers and other financial assets

| | 1.1-31.12.2012 | | | 1.1-31.12.2011 | | |
|---|---|---|---|---|---|---|
| | Customers | Other financial assets | Total | Customers | Financial institutions | Total |
| Balance at the beginning of the year | 28,420 | - | 28,420 | 21,122 | 2,178 | 23,300 |
| Impairment loss for the period | 15,960 | - | 15,960 | 9,212 | (2,178) | 7,034 |
| Collected previously written-off loans | 811 | - | 811 | 98 | - | 98 |
| Loans written-off | (1,161) | - | (1,161) | (2,012) | - | (2,012) |
| **Balance at the end of the period** | **44,030** | **0** | **44,030** | **28,420** | **0** | **28,420** |
| | | | | | | |
| Individual allowance | 28,523 | - | 28,523 | 19,696 | - | 19,696 |
| Collective allowance | 15,507 | - | 15,507 | 8,724 | - | 8,724 |
| **Total** | **44,030** | **0** | **44,030** | **28,420** | **0** | **28,420** |
| | | | | | | |
| **Net impairment loss** | | | | | | |
| Impairment loss for the period | 15,960 | - | 15,960 | 9,310 | (2,178) | 7,132 |
| Impairment of claims reversed | - | (3,700) | (3,700) | (98) | - | (98) |
| **Net impairment loss for the period** | **15,960** | **(3,700)** | **12,260** | **9,212** | **(2,178)** | **7,034** |

## 66. Renegotiated loans

Financial restructuring and renegotiation of loans to the Group's customers acquired from LBI 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 2012 the Bank continued its focus and effort in restructuring loans to individuals and companies.

## 67. Large exposures

At 31 December 2012, two Group clients were rated as large exposures (31 December 2011: 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 2012 and 2011.

At 31 December 2012, no exposure exceeded 20% (31 December 2011: 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 2012** | Number of large exposures | Large exposures |
|---|---|---|
| Large exposures above 20% of the Group's capital base | - | - |
| Large exposures between 10% and 20% of the Group's capital base | 2 | 71,610 |
| **Total** | **2** | **71,610** |
| | | |
| Utilisation ratio (400% max limit) | | 32% |
| | | |
| **At 31 December 2011** | | |
| 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 ratio (400% max limit) | | 42% |

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### 68. Bonds and debt instruments

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

| Carrying amount | 2012 | 2011 |
|---|---|---|
| Aaa | 55,699 | 61,752 |
| Aa3 | - | 38 |
| Baa1 to Baa3 | 160,087 | 144,791 |
| Lower than Baa3 | - | 959 |
| Unrated | 12,422 | 14,308 |
| **Total** | **228,208** | **221,848** |

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 2012 | Past due 0 - 90 days | Past due over 90 days | Carrying amount |
|---|---|---|---|
| Financial institutions | - | 8,995 | 8,995 |
| Holding companies | - | 147 | 147 |
| Public entities | - | 54 | 54 |
| Real estate companies | - | 3 | 3 |
| **Total** | **0** | **9,199** | **9,199** |
| | | | |
| **At 31 December 2011** | | | |
| Financial institutions | - | 8,434 | 8,434 |
| Holding companies | - | 484 | 484 |
| **Total** | **0** | **8,918** | **8,918** |

### 69. Derivative instruments

The following table summarises the Group's exposure in derivative instruments, classified by the Bank into equivalent Moody's ratings by counterparty:

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| | Notional | Fair value | | Notional | Fair value | |
| | amount | Assets | Liabilities | amount | Assets | Liabilities |
| Aa3 | 774 | 3 | - | 635 | - | 2 |
| A1 to A3 | 32,202 | 504 | 54 | 64,832 | 100 | 1,254 |
| Baa1 to Baa3 | 19,076 | 533 | 406 | 1,715 | - | 450 |
| Unrated | 11,986 | 3 | 59 | 10,664 | 59 | 24 |
| **Total** | **64,038** | **1,043** | **519** | **77,846** | **159** | **1,729** |

## Liquidity risk

### 70. 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 and financial assets.

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### 71. Liquidity risk management

A liquidity management policy for the Bank and its subsidiaries is in place and is 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 policy is built on a framework published in Basel III standards on liquidity risk measurement. The Group has performed monthly reports on new liquidity measurements set forward in the framework in 2012 and will continue implementation on those measurements in the year 2013.

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 organisation. 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% and the ratio of cash and cash equivalents to on-demand deposits to stay above 5%. The Bank submits monthly reports on its liquidity position to the Central Bank of Iceland and the Icelandic Financial Supervisory Authority. The Group has implemented a risk appetite where these rules and guidelines as well as inner requirements within the Bank set benchmark for liquidity management.

The Group's liquidity risk is managed centrally by Treasury and is monitored by Market 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.

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 financing counterparties 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.

Market Risk Unit conducts weekly 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). Another method the Group uses is the cash ratio which shows the ratio of on-demand deposits that the Group could deliver with cash and cash equivalents such as cash at hand, balances with Central Bank and loans to financial institutions (maturity within seven days). The core liquidity ratio as at 31 December 2012 was 48% (31 December 2011: 43%) and the ratio of cash and cash equivalents to on-demand deposits was 12% (31 December 2011: 20%). The following table shows various values of the core liquidity ratio and cash ratio in the year 2012 and 2011. Aggregated values for the core liquidity ratio are based on daily values and aggregated values for the cash ratio are based on monthly values:

| | Core Liquidity ratio | | Cash ratio | |
|---|---|---|---|---|
| | 2012 | 2011 | 2012 | 2011 |
| Year end | 48% | 43% | 12% | 20% |
| Maximum | 51% | 57% | 32% | 27% |
| Minimum | 36% | 42% | 12% | 17% |
| Average | 45% | 48% | 20% | 21% |

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## 72. Deposit stickiness

Stickiness is a method that the bank uses to estimate the stability of the deposit base. 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 seven different groups representing 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:

| | | 31/12/2012 | | 31/12/2011 | |
|---|---|---|---|---|---|
| **Groups** | **Criteria** | **% of total** | **Amount** | **% of total** | **Amount** |
| Individuals | Individuals | 42.6% | 221,617 | 40.6% | 226,132 |
| Small and medium size corporates | Businesses that have less than 1 million EUR in deposits | 9.7% | 50,593 | 9.5% | 52,999 |
| Large corporates | Businesses that have greater than or equal to 1 million EUR in deposits | 11.7% | 60,934 | 24.5% | 136,327 |
| Financial institutions, in resolution process | Financial institutions in resolution process | 9.6% | 50,083 | 5.4% | 29,995 |
| Government, municipalities and Central Bank | Government, municipalities and Central Bank | 6.0% | 31,353 | 4.4% | 24,604 |
| Financial institutions, securities firms and incurance companies | Financial institutions, securities firms and incurance companies | 19.6% | 101,857 | 14.9% | 82,881 |
| Other foreign counterparties | Businesses with residency outside of Iceland | 0.6% | 3,339 | 0.6% | 3,528 |
| **Total** | | **100%** | **519,776** | **100%** | **556,466** |

The table above shows the deposit base split between different groups at year end 2012 and 2011 from the estimated most sticky group to the least sticky.

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## 73. Maturity analysis of financial assets and liabilities

The following table shows a maturity analysis of the Group's financial instruments as at 31 December 2012:

| 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 | 25,898 | - | - | - | - | 25,898 | 25,898 |
| Bonds and debt instruments | - | 52,191 | 12,202 | 48,362 | 158,688 | 271,443 | 228,208 |
| Loans and advances to financial institutions | - | 55,035 | 7,726 | 1,591 | - | 64,352 | 64,349 |
| Loans and advances to customers | 15,169 | 68,164 | 97,531 | 396,142 | 374,154 | 951,160 | 666,087 |
| Other financial assets | - | 10,016 | - | 465 | - | 10,481 | 10,481 |
| **Total** | **41,067** | **185,406** | **117,459** | **446,560** | **532,842** | **1,323,334** | **995,023** |
| | | | | | | | |
| **Derivative financial assets** | | | | | | | |
| **Gross settled derivatives** | | | | | | | 1,040 |
| Inflow | - | 31,169 | - | - | - | 31,169 | |
| Outflow | - | (33,694) | - | - | - | (33,694) | |
| Total | **0** | **(2,525)** | **0** | **0** | **0** | **(2,525)** | **1,040** |
| **Net settled derivatives** | - | 3 | - | - | - | 3 | 3 |
| **Total** | **0** | **(2,522)** | **0** | **0** | **0** | **(2,522)** | **1,043** |
| | | | | | | | |
| **Non-derivative financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (97,646) | (1,054) | (18) | - | - | (98,718) | (98,718) |
| Deposits from customers | (310,088) | (52,739) | (33,049) | (26,362) | (4,137) | (426,375) | (421,058) |
| Short positions | - | (8,918) | - | - | - | (8,918) | (8,918) |
| Secured bonds | - | (1,164) | (3,401) | (184,607) | (60,329) | (249,501) | (221,791) |
| Contingent bond | - | - | - | (90,261) | (23,351) | (113,612) | (87,474) |
| Other financial liabilities | - | (14,369) | - | - | - | (14,369) | (14,369) |
| **Total** | **(407,734)** | **(78,244)** | **(36,468)** | **(301,230)** | **(87,817)** | **(911,493)** | **(852,328)** |
| | | | | | | | |
| **Off-balance sheet items** | | | | | | | |
| Financial guarantees and underwriting commitments | (297) | (19,855) | (3,434) | (2,102) | (4,976) | (30,664) | |
| Undrawn loan commitments | (32,908) | - | - | - | - | (32,908) | |
| Undrawn overdraft/credit card | (55,190) | - | - | - | - | (55,190) | |
| **Total** | **(88,395)** | **(19,855)** | **(3,434)** | **(2,102)** | **(4,976)** | **(118,762)** | **0** |
| | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet items** | **(496,129)** | **(98,099)** | **(39,902)** | **(303,332)** | **(92,793)** | **(1,030,255)** | **(852,228)** |
| | | | | | | | |
| **Derivative financial liabilities** | | | | | | | |
| **Gross settled derivatives** | | | | | | | (490) |
| Inflow | - | 26,093 | 276 | 839 | 284 | 27,492 | |
| Outflow | - | (22,650) | (347) | (1,074) | (371) | (24,441) | |
| Total | **0** | **3,443** | **(71)** | **(235)** | **(87)** | **3,051** | **(490)** |
| **Net settled derivatives** | - | (29) | - | - | - | (29) | (29) |
| **Total** | **0** | **3,414** | **(71)** | **(235)** | **(87)** | **3,022** | **(519)** |
| | | | | | | | |
| **Net liquidity position** | **(455,062)** | **88,199** | **77,486** | **142,993** | **439,962** | **293,579** | **143,219** |

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### 73. 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 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) | (19,879) | (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)** | **(19,879)** | **(2,984)** | **(1,472)** | **0** | **(93,913)** | **0** |
| | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet items** | **(545,818)** | **(80,639)** | **(40,544)** | **(262,720)** | **(157,703)** | **(1,068,924)** | **(907,178)** |
| | | | | | | | |
| **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)** | **150,246** | **99,413** | **78,971** | **392,942** | **265,167** | **65,507** |

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 categorised as outflows in the first time bucket. The Groups liquidity position can withstand 50% outflow of deposits (see note 71). Further information on the Group's liquidity management can also be found in the forementioned note.

The amounts in the maturity analyses as at year end 2012 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). For loans and advances in moratorium or in the process of liquidation the Group estimates the amounts from 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. These bonds and loans all fall in time band of 1-5 years.

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### 73. 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 72 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 2012 and 2011. When managing liquidity risk the Group regards spot deals as a non-derivative assets or liabilities.

### 74. 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 2012:

| 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 | 2,109 | 122,299 | 45,852 | 172,123 | 24,002 | 366,385 | 335,019 |
| ISK | 38,958 | 63,107 | 71,607 | 274,436 | 508,840 | 956,948 | 660,004 |
| **Total** | **41,067** | **185,406** | **117,459** | **446,559** | **532,842** | **1,323,333** | **995,023** |
| **Derivative financial assets** | | | | | | | |
| Total in foreign currencies | - | (1,964) | - | - | - | (1,964) | 1,040 |
| ISK | - | (558) | - | - | - | (558) | 3 |
| **Total** | **0** | **(2,522)** | **0** | **0** | **0** | **(2,522)** | **1,043** |
| **Non-derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | (62,542) | (5,127) | (6,495) | (274,868) | (83,680) | (432,712) | (378,847) |
| ISK | (345,192) | (73,117) | (29,973) | (26,362) | (4,137) | (478,781) | (473,480) |
| **Total** | **(407,734)** | **(78,244)** | **(36,468)** | **(301,230)** | **(87,817)** | **(911,493)** | **(852,328)** |
| **Off-balance sheet items** | | | | | | | |
| Total in foreign currencies | (13,398) | (19,144) | (2,509) | (571) | (286) | (35,909) | - |
| ISK | (74,997) | (711) | (924) | (1,530) | (4,689) | (82,852) | - |
| **Total** | **(88,395)** | **(19,855)** | **(3,434)** | **(2,102)** | **(4,976)** | **(118,762)** | **0** |
| **Derivative financial liabilities** | | | | | | | |
| Total in foreign currencies | - | 9,228 | 101 | 302 | 101 | 9,731 | (490) |
| ISK | - | (5,814) | (172) | (537) | (188) | (6,709) | (29) |
| **Total** | **0** | **3,414** | **(71)** | **(235)** | **(87)** | **3,022** | **(519)** |
| **Net liquidity position in foreign currencies** | **(73,831)** | **105,292** | **36,949** | **(103,014)** | **(59,863)** | **(94,469)** | **(43,278)** |
| **Net liquidity position in ISK** | **(381,231)** | **(17,093)** | **40,538** | **246,007** | **499,826** | **388,048** | **186,498** |
| **Net liquidity position** | **(455,062)** | **88,199** | **77,486** | **142,992** | **439,963** | **293,578** | **143,219** |

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## 74. 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 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)** | **0** |
| **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)** | **(423)** |
| **Net liquidity position in ISK** | **(406,172)** | **(1,179)** | **62,496** | **157,433** | **483,684** | **296,262** | **65,930** |
| **Net liquidity position** | **(474,905)** | **168,746** | **99,413** | **78,971** | **392,942** | **265,167** | **65,507** |

The amounts in the maturity analysis as at 31 December 2012 and 31 December 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 as disclosed in Note 73.

## Market risk

## 75. 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.

## 76. 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) managed by 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 for 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 and the Market Making department within Markets are responsible for managing market-related positions under the supervision of Market Risk. The objective of market risk management is to identify, locate and monitor market risk exposures and analysing and reporting to appropriate parties.

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### 76. Market risk management (continued)

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 Market Risk monitors the limits set in the Bank's risk appetite and submits these and other market risk measurements to the Risk and Finance Committee every other week. 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 2012 and 2011:

The following table summarises the Group's exposure to market risk as at 31 December 2012 and 2011:

| | 31.12.2012 | 31.12.2011 |
|---|---|---|
| **Market risk factor** | % of RWA | % of RWA |
| Equity price risk | 6.3% | 7.7% |
| Interest rate risk | 2.0% | 2.6% |
| Foreign exchange risk | 2.9% | 3.1% |
| **Total** | **11.2%** | **13.4%** |

The currency risk in the Group's trading portfolios is disclosed together with that in its non-trading portfolios in Notes 81-82, together with the related sensitivity analysis.

### 77. 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 Market 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 7). The amounts presented are categorised by the earlier of either the contractual repricing or the maturity date.

| At 31 December 2012 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 25,898 | - | - | - | 25,898 |
| Bonds and debt instruments | 214,996 | 6,395 | 1,331 | 5,486 | 228,208 |
| Derivative instruments | 1,043 | - | - | - | 1,043 |
| Loans and advances to financial institutions | 55,032 | 7,726 | 1,591 | - | 64,349 |
| Loans and advances to customers | 483,493 | 62,515 | 58,198 | 61,881 | 666,087 |
| Other financial assets | 10,017 | - | 464 | - | 10,481 |
| **Total** | **790,479** | **76,636** | **61,584** | **67,367** | **996,066** |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | (98,718) | - | - | - | (98,718) |
| Deposits from customers | (418,750) | (1,861) | (447) | - | (421,058) |
| Derivative instruments and short positions | (521) | (5,257) | (2,717) | (943) | (9,438) |
| Borrowings | (221,791) | - | - | - | (221,791) |
| Contingent bond | (87,474) | - | - | - | (87,474) |
| Other financial liabilities | (14,369) | - | - | - | (14,369) |
| **Total** | **(841,623)** | **(7,118)** | **(3,164)** | **(943)** | **(852,848)** |
| | | | | | |
| Net on-balance sheet position | (51,144) | 69,518 | 58,420 | 66,424 | 143,218 |
| Net off-balance sheet position | 698 | (133) | (418) | (146) | |
| | | | | | |
| **Total interest repricing gap** | **(50,446)** | **69,385** | **58,002** | **66,278** | |

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### 77. 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** | |

### 78. 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 2012 and 2011 and cash flows for the next 12 months, assuming a constant position.

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| **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, non-CPI indexed | 100 | 99 | (132) | 100 | 196 | (195) |
| ISK, CPI indexed | 50 | 129 | (122) | 50 | 77 | (73) |
| USD | 20 | 8 | (8) | 20 | - | - |
| **Total** | | **236** | **(262)** | | **273** | **(268)** |

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):

| | 2012 | | 2011 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **Increase** | **Decrease** | **Increase** | **Decrease** |
| ISK | 186 | (186) | 956 | (956) |
| EUR | - | - | 6 | (6) |
| DKK | - | - | 97 | (97) |
| SEK | - | - | 302 | (302) |
| NOK | 278 | (278) | 378 | (378) |
| Other | - | - | 39 | (39) |
| **Total** | **464** | **(464)** | **1,778** | **(1,778)** |

### 78. Sensitivity analysis for trading portfolios (continued)

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):

| | 2012 | | 2011 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **Increase** | **Decrease** | **Increase** | **Decrease** |
| ISK | 1,849 | (1,849) | 1,983 | (1,983) |
| EUR | 1,138 | (1,138) | 811 | (811) |
| GBP | - | - | 1 | (1) |
| **Total** | **2,987** | **(2,987)** | **2,795** | **(2,795)** |

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.

### 79. 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 quarterly 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 held constant, as related to risk exposure at year end 2012 and 2011 and cash flows for the next 12 months, assuming a constant position.

| | 2012 | | | 2011 | | |
|---|---|---|---|---|---|---|
| **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 | 107 | (107) | 100 | 21 | (21) |
| ISK, CPI indexed | 50 | 47 | (47) | 50 | 93 | (93) |
| EUR | 20 | 35 | (35) | 20 | 18 | (18) |
| Other | 20 | 18 | (18) | 20 | 22 | (22) |
| **Total** | | **207** | **(207)** | | **154** | **(154)** |

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.

## 80. 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. To mitigate this imbalance, which the bank is in a limitied position to do, the bank offers non-CPI indexed loans and CPI-indexed deposits.

CPI indexation risk is managed centrally within the Group by the Treasury of the Bank, and is monitored by Market Risk. At 31 December 2012 the CPI imbalance, calculated as the difference between CPI-indexed financial assets and liabilities, was ISK 145,784 million (31 December 2011: 128,958 million). This increase in CPI imbalance is mainly caused by loan impairment re-evaluation.

| **Carrying amount** | **31.12.2012** | **31.12.2011** |
|---|---|---|
| **Assets** | | |
| Bonds and debt instruments | 7,586 | 10,812 |
| Loans and advances to customers | 239,432 | 217,131 |
| **Total** | **247,018** | **227,943** |
| | | |
| **Liabilities** | | |
| Due to financial institutions and Central Bank | (23) | (123) |
| Deposits from customers | (100,768) | (97,127) |
| Short positions | - | (924) |
| **Total** | **(100,791)** | **(98,174)** |
| | | |
| Total on-balance sheet position | 146,227 | 129,769 |
| Total off-balance sheet position | (443) | (811) |
| | | |
| **Total CPI indexation balance** | **145,784** | **128,958** |

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 2012, with no change in other variables, would have changed net interest income by ISK 1,462 million (31 December 2011: 1,298 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. However, in a scenario of ongoing high (low) inflation, floating unindexed interest rate are likely to remain higher (lower) than would be the case in the reverse scenario, thus counterbalancing the positive (negative) income effects for the Group in the longer term.

## 81. 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 15% of the Bank's Capital base, in each currency and for all currencies combined. The Bank submits daily and monthly reports to the Central Bank with information on its foreign exchange balance.

The Group's combined net foreign exchange balance as at 31 December 2012 was -9,1% of the Group's Capital base (2011: +10,4%). Uncertainty regarding the denomination currencies of the Groups loan portfolio has not been fully resolved in the year 2012. As explained in note 4 and 37 there are few rulings concerning these denomination currencies that the Icelandic courts have not passed judgement on yet.

## 82. Concentration of currency risk

The following tables summarise the Group's exposure to currency risk at year end 2012 and 2011. The off-balance sheet amounts shown are the notional amounts of the Group's derivative instruments.

Amounts presented under assets and liabilities include all spot deals at year end 2012 and 2011. When managing liquidity risk the Group regards spot deals as a non-derivative assets or liabilities.

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## 82. Concentration of currency risk (continued)

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. 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 balance, which amounts to 87,474 million into Euros which shall be the new balance of the contingent bond.

| At 31 December 2012 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 400 | 173 | 229 | 13 | 40 | 377 | 1,232 |
| Bonds and debt instruments | 8,995 | 35,200 | 34,483 | - | - | - | 78,678 |
| Equities and equity instruments | 11,381 | - | 1 | - | - | 3,339 | 14,721 |
| Derivative instruments | 1,037 | - | 3 | - | - | - | 1,040 |
| Loans and advances to financial institutions | 32,399 | 1,630 | 9,360 | 3,095 | 2,961 | 4,600 | 54,045 |
| Loans and advances to customers | 90,044 | 19,250 | 58,169 | 12,406 | 12,777 | 6,642 | 199,288 |
| Other assets | 502 | - | 1,761 | 1 | - | 30 | 2,294 |
| Assets classified as held for sale | 288 | - | - | - | - | - | 288 |
| **Total** | **145,046** | **56,253** | **104,006** | **15,515** | **15,778** | **14,988** | **351,586** |
| | | | | | | | |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (5,438) | (4,068) | (4,870) | - | (148) | (823) | (15,348) |
| Deposits from customers | (15,814) | (6,007) | (21,671) | (520) | (428) | (6,456) | (50,895) |
| Derivative instruments and short positions | (176) | - | (314) | - | - | - | (491) |
| Secured bonds | (109,380) | (42,397) | (70,013) | - | - | - | (221,791) |
| Contingent bond | (87,474) | | | | | | (87,474) |
| Other liabilities | (580) | (70) | (2,197) | (6) | (2) | (536) | (3,391) |
| **Total** | **(218,862)** | **(52,542)** | **(99,065)** | **(526)** | **(578)** | **(7,815)** | **(379,390)** |
| | | | | | | | |
| Net on-balance sheet position | (73,816) | 3,711 | 4,941 | 14,990 | 15,201 | 7,171 | **(27,802)** |
| Net off-balance sheet position | 49,234 | (2,948) | (5,532) | (13,882) | (13,768) | (5,337) | **7,767** |
| | | | | | | | |
| **Net currency position** | **(24,582)** | **763** | **(591)** | **1,108** | **1,433** | **1,834** | **(20,035)** |

| 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** |

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### 83. 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 82.

| | 2012 | | 2011 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **-10%** | **+10%** | **-10%** | **+10%** |
| EUR | (2,458) | 2,458 | 1,414 | (1,414) |
| GBP | 76 | (76) | (775) | 775 |
| USD | (59) | 59 | 189 | (189) |
| JPY | 111 | (111) | 382 | (382) |
| CHF | 143 | (143) | 528 | (528) |
| Other | 183 | (183) | 266 | (266) |
| **Total** | **(2,004)** | **2,004** | **2,004** | **(2,004)** |

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.

### 84. Foreign exchange rates used

The following foreign exchange rates were used by the Group:

| | At 31 December 2012 | At 31 December 2011 | % Change | Average for 1.1-31.12 2012 | Average for 1.1-31.12 2011 |
|---|---|---|---|---|---|
| EUR/ISK | 168.95 | 158.80 | 6.4% | 161.60 | 161.18 |
| GBP/ISK | 207.22 | 190.29 | 8.9% | 198.77 | 185.68 |
| USD/ISK | 128.16 | 122.22 | 4.9% | 125.07 | 115.55 |
| JPY/ISK | 1.49 | 1.59 | (6.3%) | 1.57 | 1.45 |
| CHF/ISK | 139.94 | 130.79 | 7.0% | 134.15 | 131.04 |
| CAD/ISK | 128.73 | 120.24 | 7.1% | 125.00 | 117.18 |
| DKK/ISK | 22.64 | 21.36 | 6.0% | 21.71 | 21.64 |
| NOK/ISK | 22.96 | 20.51 | 11.9% | 21.59 | 20.72 |
| SEK/ISK | 19.68 | 17.81 | 10.5% | 18.58 | 17.93 |

## Operational risk

### 85. 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 coordinates 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.

## Consolidated Key Figures

86. **Operations by years**

| Operations | 2012 | 2011 | 2010 | 2009 | 7.10. - 31.12.2008 |
|---|---|---|---|---|---|
| Interest income | 64,661 | 60,831 | 61,060 | 81,476 | 28,021 |
| Interest expense | (29,077) | (28,182) | (36,374) | (66,902) | (23,730) |
| **Net interest income** | **35,584** | **32,649** | **24,685** | **14,574** | **4,291** |
| Net adjustments in valuation of loans and advances | (4,391) | (23,587) | 641 | 6,954 | (1,256) |
| **Net interest income after adjustments in valuation** | **31,193** | **9,062** | **25,326** | **21,528** | **3,035** |
| Fee and commission income | 7,696 | 7,437 | 6,292 | 6,835 | 1,710 |
| Fee and commission expense | (3,248) | (3,014) | (2,710) | (2,622) | (723) |
| **Net fee and commission income** | **4,448** | **4,424** | **3,582** | **4,213** | **987** |
| **Other operating income** | **13,500** | **17,258** | **21,941** | **4,983** | **(6,864)** |
| **Net operating income** | **49,141** | **30,743** | **50,849** | **30,725** | **(2,842)** |
| Salaries and related expenses | (13,176) | (11,990) | (9,331) | (8,468) | (1,506) |
| Administrative expenses | (9,887) | (9,482) | (8,485) | (7,706) | (5,100) |
| Contribution to the Depositors' and Investors' Guarantee Fund | (1,042) | (583) | (680) | (680) | (665) |
| **Operating expenses** | **(24,105)** | **(22,055)** | **(18,496)** | **(16,854)** | **(7,271)** |
| **Share of profit of associates, net of income tax** | **2,449** | **1,418** | **291** | **383** | **193** |
| **Pre-tax profit** | **27,485** | **10,105** | **32,644** | **14,253** | **(9,920)** |
| Income and bank tax | (4,125) | 597 | (8,182) | (615) | 2,941 |
| **Profit from continuing operations** | **23,360** | **10,703** | **24,462** | **13,638** | **(6,979)** |
| **Profit for the period from discontinued operations, net of income tax** | **2,134** | **6,255** | **2,769** | **693** | **43** |
| **Net profit** | **25,494** | **16,957** | **27,231** | **14,332** | **(6,936)** |
| | | | | | |
| **Attributable to:** | | | | | |
| Shareholders of Landsbankinn | 25,439 | 16,973 | 27,228 | 14,477 | (6,945) |
| Minority interests | 55 | (16) | 3 | (145) | 9 |

| Balance Sheet | 2012 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Cash and cash balances with Central Bank | 25,898 | 8,823 | 47,777 | 26,174 | 30,071 |
| Bonds and debt instruments | 228,208 | 221,848 | 161,559 | 165,721 | 189,121 |
| Equities and equity instruments | 36,881 | 46,037 | 29,429 | 23,411 | 39,681 |
| Loans and advances to financial institutions | 64,349 | 100,133 | 91,882 | 83,129 | 8,845 |
| Loans and advances to customers | 666,087 | 639,130 | 592,954 | 667,122 | 705,182 |
| Other assets | 38,044 | 65,959 | 28,743 | 31,666 | 56,907 |
| Assets classified as held for sale | 25,320 | 53,552 | 128,789 | 63,878 | 7,584 |
| **Total assets** | **1,084,787** | **1,135,482** | **1,081,133** | **1,061,101** | **1,037,391** |
| | | | | | |
| Due to financial institutions and Central Bank | 98,718 | 112,876 | 147,478 | 98,228 | 132,219 |
| Deposits from customers | 421,058 | 443,590 | 371,558 | 452,655 | 431,006 |
| Secured bonds | 221,791 | 277,076 | 261,313 | 306,493 | 305,056 |
| Contingent bond | 87,474 | 60,826 | 26,510 | 10,241 | - |
| Other liabilities | 29,687 | 31,485 | 27,800 | 14,203 | 21,385 |
| Liabilities associated with assets classified as held for sale | 893 | 9,385 | 61,609 | 21,689 | 4,440 |
| Equity | 225,166 | 200,244 | 184,866 | 157,593 | 143,285 |
| **Total liabilities and equity** | **1,084,787** | **1,135,482** | **1,081,133** | **1,061,101** | **1,037,391** |

| Key ratios | 2012 | 2011 | 2010 | 2009 |
|---|---|---|---|---|
| Return on equity before taxes (Average equity) | 14.0% | 8.1% | 20.8% | 9.9% |
| Return on equity after taxes (Average equity) | 12.0% | 8.4% | 16.0% | 9.5% |
| Equity ratio (CAD) | 25.1% | 21.4% | 19.5% | 15.0% |
| Cost-income ratio | 45.0% | 40.6% | 36.8% | 70.9% |
| Operating expenses as a ratio of average total assets | 2.2% | 2.0% | 1.7% | 1.6% |
| Interest spread as a ratio of average total assets | 3.2% | 2.9% | 2.3% | 1.4% |
| Loans / deposits | 158.2% | 144.1% | 159.6% | 147.4% |
| Deposits / total assets | 38.8% | 39.1% | 34.4% | 42.6% |
| Number of positions at year-end | 1,233 | 1,311 | 1,146 | 1,161 |

All amounts are in ISK million

## 87. Operations by quarters (Unaudited)

| Operations | 2012 Q4* | 2012 Q3 | 2012 Q2 | 2012 Q1 | 2011 Q4* | 2011 Q3 | 2011 Q2 | 2011 Q1 |
|---|---|---|---|---|---|---|---|---|
| Interest income | 16,624 | 12,962 | 18,306 | 16,769 | 15,091 | 14,242 | 18,315 | 13,183 |
| Interest expense | (7,395) | (5,180) | (8,286) | (8,216) | (7,033) | (6,500) | (8,611) | (6,038) |
| **Net interest income** | **9,229** | **7,782** | **10,020** | **8,553** | **8,058** | **7,742** | **9,704** | **7,145** |
| Net adjustments to loans and advances acquired at deep discount | 17,935 | 8,213 | 3,610 | 7,562 | 38,291 | 7,212 | 8,994 | 3,992 |
| Loss from foreign currency linkage of loans and advances to customers | - | (2,120) | - | - | (40,726) | - | - | - |
| Net impairment loss | (1,307) | (4,514) | (5,151) | (1,288) | (4,323) | (318) | 16 | (2,409) |
| Fair value change of contingent bond | (13,932) | (5,201) | (2,251) | (5,947) | (17,623) | (8,775) | (4,564) | (3,354) |
| **Net adjustments in valuation** | **2,696** | **(3,622)** | **(3,792)** | **327** | **(24,381)** | **(1,881)** | **4,446** | **(1,771)** |
| **Net interest income after net adjustments in valuation** | **11,925** | **4,160** | **6,228** | **8,880** | **(16,323)** | **5,861** | **14,150** | **5,374** |
| Fee and commission income | 2,103 | 1,917 | 1,836 | 1,840 | 1,996 | 1,843 | 1,955 | 1,643 |
| Fee and commission expense | (777) | (887) | (746) | (838) | (917) | (716) | (768) | (613) |
| **Net fee and commission income** | **1,326** | **1,030** | **1,090** | **1,002** | **1,079** | **1,127** | **1,187** | **1,030** |
| Net gain on financial assets designated as at fair value through profit or loss | 2,446 | (549) | 1,429 | 2,377 | 5,427 | 1,634 | 1,260 | 9,138 |
| Net gain on financial assets and liabilities held for trading | 356 | 586 | 112 | 1,115 | 1,485 | (241) | (706) | 471 |
| Net foreign exchange gain (loss) | 2,831 | 899 | (1,280) | 2,116 | 290 | (910) | 2,440 | (2,579) |
| Other income and (expenses) | 316 | 255 | 269 | 222 | (906) | 603 | (9) | (138) |
| **Other net operating income** | **5,949** | **1,191** | **530** | **5,830** | **6,296** | **1,086** | **2,985** | **6,892** |
| **Total operating income** | **19,200** | **6,381** | **7,848** | **15,712** | **(8,948)** | **8,074** | **18,322** | **13,296** |
| Salaries and related expenses | 3,477 | 3,103 | 3,364 | 3,232 | 4,044 | 2,703 | 2,933 | 2,310 |
| Other operating expenses | 2,112 | 2,250 | 2,331 | 2,185 | 2,304 | 1,590 | 2,622 | 1,951 |
| Depreciation and amortisation | 181 | 177 | 181 | 180 | 240 | 182 | 172 | 177 |
| Contribution to the Depositors' and Investors' Guarantee Fund | 275 | 213 | 204 | 350 | 77 | 106 | 150 | 250 |
| Acquisition-related costs | 290 | - | - | - | (3) | 7 | 241 | - |
| **Total operating expenses** | **6,335** | **5,743** | **6,080** | **5,947** | **6,662** | **4,588** | **6,118** | **4,688** |
| Share of profit of equity-accounted associates, net of income tax | 1,762 | 14 | 673 | - | 257 | (12) | 1,182 | (10) |
| **Profit before tax** | **14,627** | **652** | **2,441** | **9,765** | **(15,353)** | **3,474** | **13,386** | **8,598** |
| Income tax | (1,925) | 1,277 | (400) | (1,877) | 4,285 | (795) | (1,947) | (132) |
| Tax on liabilities of financial institutions | (399) | (265) | (205) | (331) | (474) | (120) | (120) | (100) |
| **Profit for the year from continuing operations** | **12,303** | **1,664** | **1,836** | **7,557** | **(11,542)** | **2,559** | **11,319** | **8,366** |
| Profit for the year from discontinued operations, net of income tax | (350) | - | 2,312 | 172 | 1,546 | (40) | 424 | 4,325 |
| **Profit for the period** | **11,953** | **1,664** | **4,148** | **7,729** | **(9,996)** | **2,519** | **11,743** | **12,691** |

| Balance sheet | 31/12/2012 | 30/09/2012 | 30/06/2012 | 31/03/2012 | 31/12/2011 | 30/09/2011 | 30/06/2011 | 31/03/2011 |
|---|---|---|---|---|---|---|---|---|
| Cash and cash balances with Central Bank | 25,898 | 25,235 | 16,364 | 25,494 | 8,823 | 22,229 | 30,374 | 34,256 |
| Bonds and debt instruments | 228,208 | 217,485 | 203,863 | 202,195 | 221,848 | 215,008 | 185,417 | 166,008 |
| Equities and equity instruments | 36,881 | 33,198 | 38,161 | 42,803 | 46,037 | 28,801 | 38,461 | 38,043 |
| Loans and advances to financial institutions | 64,349 | 60,787 | 59,529 | 130,946 | 100,133 | 81,616 | 97,597 | 104,422 |
| Loans and advances to customers | 666,087 | 657,050 | 666,890 | 653,949 | 639,130 | 643,880 | 653,189 | 621,896 |
| Other assets | 38,044 | 37,688 | 37,082 | 66,771 | 65,959 | 78,735 | 66,582 | 93,543 |
| Assets classified as held for sale | 25,320 | 25,382 | 26,684 | 52,104 | 53,552 | 53,981 | 54,661 | 47,422 |
| **Total assets** | **1,084,787** | **1,056,825** | **1,048,573** | **1,174,262** | **1,135,482** | **1,124,250** | **1,126,281** | **1,105,590** |
| Due to financial institutions and Central Bank | 98,718 | 90,206 | 91,018 | 115,300 | 112,876 | 112,642 | 134,542 | 131,648 |
| Deposits from customers | 421,058 | 439,853 | 440,392 | 455,402 | 443,590 | 450,163 | 425,158 | 436,688 |
| Secured bonds | 221,791 | 211,699 | 209,028 | 289,908 | 277,076 | 271,566 | 273,922 | 269,781 |
| Contingent bond | 87,474 | 74,225 | 69,024 | 66,773 | 60,826 | 43,203 | 34,428 | 29,864 |
| Other liabilities | 29,687 | 26,561 | 26,130 | 29,166 | 31,485 | 28,465 | 35,618 | 28,142 |
| Liabilities associated with assets classified as held for sale | 893 | 603 | 959 | 9,839 | 9,385 | 7,985 | 14,906 | 13,617 |
| Equity | 225,166 | 213,678 | 212,022 | 207,874 | 200,244 | 210,226 | 207,707 | 195,849 |
| **Total liabilities and equity** | **1,084,787** | **1,056,825** | **1,048,573** | **1,174,262** | **1,135,482** | **1,124,250** | **1,126,281** | **1,105,590** |

*The first three quarter results for the years 2012 and 2011 were reviewed by the Bank's independent auditors.

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# 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.

Landsbankinn hf. Consolidated Financial Statements 2011 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 5 All amounts are in ISK million

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

| 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.

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## 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.

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## 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.

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## 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** |

Landsbankinn hf. Consolidated Financial Statements 2011 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

## 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)** |

Landsbankinn hf. Consolidated Financial Statements 2011 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

| Bonds and debt instruments | 2011 Loans and receivables | 2011 Held for trading | 2011 Designated as at fair value | 2011 Total | 2010 Loans and receivables | 2010 Held for trading | 2010 Designated as at fair value | 2010 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

| Foreign exchange derivatives | 2011 Notional amount | 2011 Fair value Assets | 2011 Fair value Liabilities | 2010 Notional amount | 2010 Fair value Assets | 2010 Fair value 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.

All amounts are in ISK million

## 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 | Total assets | Total liabilities | Profit (loss) | Ownership interest | Share of profit of associates | Carrying amount |
|---|---|---|---|---|---|---|
| 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.

All amounts are in ISK million

## 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.

All amounts are in ISK million

### 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** |

Landsbankinn hf. Consolidated Financial Statements 2011 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** |

All amounts are in ISK million

## 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)** |

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## 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% |

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## 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**<br>Internal Audit, Remuneration Committee, Audit and Risk Committee, Governance Committee | | | | |
| **Key management bodies and committees** | **The CEO**<br>Risk and Finance Committee<br>Credit Committee<br>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

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| Industry sectors | Gross carrying amount | Allowance for impairment | Carrying amount | Gross carrying amount | Allowance for impairment | 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.

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## 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.

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## 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** | |

All amounts are in ISK million

## 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.

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### 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.

All amounts are in ISK million

## 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.

Landsbankinn hf. Consolidated Financial Statements 2011 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** | |

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### 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.

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

# Articles of Association

Landsbankinn hf.

# Articles of Association of Landsbankinn hf.

## Chapter I

### Name, Domicile and Purpose of the Company

#### Article 1

The Company is a limited-liability company with the name Landsbankinn hf.

#### Article 2

The address of the Company is Austurstræti 11, Reykjavík.

#### Article 3

The Company's purpose is to operate a commercial bank. The Company may pursue any and all activities of financial undertakings as provided for by current law, as well as other activities in normal connection with this.

The Company may participate in activities relevant to its operations and acquire holdings in other companies for that purpose.

## CHAPTER II

### Share capital

#### Article 4

The share capital of the Company shall be ISK 24,000,000,000.- -twenty-four billion 00/100-. The Company's share capital is divided into shares of one Icelandic króna or a multiple of this amount. One share may be issued for the entire share capital of the Company and the same applies to increased share capital.

Only a shareholders' meeting may decide on increases in share capital, either by new subscriptions or through the issue of bonus shares.

Only a shareholders' meeting can take a decision to reduce share capital.

#### Article 5

Shares shall be numbered and issued in the name of the shareholder. Share certificates confer full rights on shareholders as stipulated by the Act on Limited-Liability Companies and the Company's Articles.

The Board of Directors of the Company may issue shares electronically through a securities depository in accordance with Act No. 131/1997 on Electronic Registration of Title to Securities. Once a shareholder has made full payment for his/her shares to the Company, the securities depository will issue the shareholder with an electronic share certificate and register title to the shares, granting the shareholder full rights as provided for in the Company's Articles of Association.

**Article 6**

The Board of Directors of the Company shall maintain a register of shares, as provided for by law, including information on:

1. the date of issue of share certificates;
2. the nominal value and number of each share certificate;
3. to whom the share certificate was issued and any subsequent transfer of ownership; the name, address and identification number of the shareholder; In addition, the date of registration and any transfer of ownership shall be entered on the certificate.

The register of shares shall be kept at the Company's offices and be accessible to all shareholders wishing to acquaint themselves with it.

**Article 7**

General rules on commercial instruments apply to shares in the Company.

No privileges are conferred by shares in the Company. Shareholders shall not be subject to redemption of their shares.

Shares in the Company may be sold or mortgaged unless otherwise indicated by law.

Changes in share ownership, whether resulting from a sale, gift, inheritance, estate settlement or execution, must always be notified to the Company's office as soon as effected; the register of shares shall be revised accordingly.

A party acquiring shares in the Company may not exercise his/her rights as a shareholder unless his/her name has been entered in the register of shares or he/she has given notification and proof of ownership of the shares.

The register of shares shall be regarded by the Company as fully valid proof of title to shares and any bonus shares, announcements of meetings and all notifications shall be sent to the party currently recorded in the register as the owner of the respective shares. Dividends shall be paid to those parties registered in the register of shares at the end of the day of the Annual General Meeting, unless the Company is notified of the assignment of the dividend through the transfer of shares. The Company shall bear no responsibility for payments or notifications which may go astray as a result of failure to notify the Company of changes in ownership or residence.

**Article 8**

All shareholders are obliged, without a specific undertaking, to comply with the provisions of the Articles of Association, as they now stand or as subsequently amended in lawful fashion.

## CHAPTER III

## Shareholders’ meetings

### Article 9

Final authority in all Company dealings rests with the duly constituted shareholders’ meeting.

Shareholders, their proxies and advisors, the Company’s auditor and its CEO shall be entitled to attend shareholders’ meetings.

A shareholder may appoint a proxy to attend a shareholders’ meeting on his/her behalf. A proxy must produce a written, dated power of attorney.

A shareholder may attend a meeting accompanied by an advisor. An advisor shall not have the right to speak, make a motion or vote at a shareholders’ meeting.

The Company’s auditor and CEO shall have full rights to speak and make motions at shareholders’ meetings, even if they are not shareholders.

The Company’s Board of Directors may invite experts to attend certain meetings, if their opinion or assistance is required.

### Article 10

The Annual General Meeting shall be held before the end of April each year.

The Annual General Meeting shall be called with a notice on the radio and in daily newspapers, or by other verifiable means, with at least three weeks’ notice. The agenda of the meeting shall be specified in the announcement.

An Annual General Meeting shall be properly constituted if it has been lawfully convened, regardless of how many people attend.

### Article 11

The following items shall be dealt with at the Annual General Meeting:

1. a report from the Board of Directors on the Company’s activities during the past operating year;
2. the annual financial statements for the past operating year, together with a report from the auditor, shall be placed before the meeting for attestation;
3. a decision on the payment of a dividend and disposition of profit or loss from the past accounting year;
4. the Board of Directors proposes a remuneration policy and submits it to the meeting for approval;
5. motions for amendments to the Articles of Association, if any have been received;
6. election of the Board of Directors;
7. election of the auditor;
8. a decision on remuneration to directors for the next term of office; and
9. other business.

Elections to the Board of Directors of the Company shall be conducted in accordance with legal provisions on limited companies, currently Article 63 of Act No.

### Article 12

Extraordinary shareholders’ meetings shall be held whenever the Board of Directors deems it necessary, in accordance with a resolution, or if the elected auditor or shareholders controlling at least one-tenth of the share capital so request in writing, specifying the subject of the meeting; in such case an extraordinary shareholders’ meeting must be called within two weeks’ of receipt of such request by the Board of Directors.

An extraordinary shareholders’ meeting shall be announced with at least one week’s notice and no more than four weeks' notice. If all shareholders, or their proxies, are present, they may grant an exception to this provision. An extraordinary shareholders' meeting shall be announced by advertisement on the radio and in daily newspapers or by other verifiable means. The same rules concerning legal constitution shall apply to extraordinary shareholders' meetings as apply to the Annual General Meeting, cf. the third paragraph of Article 11.

**Article 13**

The Board of Directors may conduct shareholders' meetings electronically, either in part or entirely.

If the Board of Directors deem available equipment secure enough to hold meetings electronically and thus decides to avail itself of the authorisation provided in Paragraph 1, special mention should be made of this arrangement in the announcement of the meeting. Information on required technology, how to announce participation, the arrangement of voting, directions regarding the conferencing system and password required to access the meeting, as well as other relevant information, shall be included in the announcement of the meeting. Entering the password in the specified conferencing system shall be equivalent to the shareholder's signature and is regarded as confirmation of his/her participation in the meeting.

Shareholders intending to participate in shareholders' meetings which the Board has decided to convene electronically in accordance with Paragraph 1, shall notify the Company's office at least five days in advance and at the same time submit written questions or, as the case may be, any documents they wish to submit to the meeting.

If, in the opinion of the Board, it is not practicable to invite shareholders to participate in electronic shareholders' meetings, shareholders shall be invited to vote on proposals or participate in elections via mail. The announcement of the meeting shall include a description of voting procedures. Shareholders can request to have voting ballots sent to them by mail and must submit such requests to the Company's office at least five days prior to the advertised shareholders' meeting. Shareholders can also collect their ballots from the Company's office as of the same time limit or vote on the premises.

**Article 14**

Any shareholder is entitled to have a specific matter dealt with at a shareholders' meeting, if he/she submits a written request for such to the Board with sufficient notice to allow this to be placed on the agenda of the meeting as provided for in these Articles of Association. Candidature for the Board of Directors must be announced at least five days prior to the Annual General Meeting.

The announcement of the meeting shall list the items of business to be discussed at the shareholders' meeting. No later than one week prior to a shareholders' meeting the agenda, final motions, as well as the annual financial statements, report from the Board of Directors and auditor's report in the case of an AGM, shall be available to shareholders for inspection at the Company's office. Information on nominations to the Board of Directors shall be made available two days prior to the Annual General Meeting.

Items which have not been listed on the agenda of a shareholders' meeting may not be resolved at the meeting without the approval of all shareholders, although resolutions on these items may be passed as guidelines for the Board of Directors. Even if an item was not listed on the meeting agenda, this shall not preclude the calling of an extraordinary shareholders' meeting to discuss this item; in addition, an Annual General Meeting may always finalise items which it is required to handle by law or the Articles of Association.

Supplementary motions or amendments, legally submitted, may be raised at the meeting itself despite not having been available to shareholders beforehand.

### Article 15

The Chairman of the Board of Directors or elected Chairman of the meeting shall preside over a shareholders' meeting and the election of a meeting Secretary. The meeting Chairman shall, upon the commencement of the meeting, check whether it has been lawfully convened and is legally constituted in other respects and declare whether such is the case. He/She shall direct all discussion and voting.

Once the meeting is in session, a list of the shareholders and their proxies attending the meeting shall be compiled, in order to clarify how many shares and votes each of them controls. This list shall be used until the shareholders' meeting alters it.

### Article 16

The meeting Secretary shall take minutes of the meeting. Decisions by the shareholders' meeting, together with voting results, shall be recorded in the minutes. A list of the shareholders present and their proxies shall be entered in the minutes or accompany them. The minutes shall be read aloud prior to the end of the meeting and any comments made recorded therein. The Chairman and Secretary of the meeting shall sign the minutes.

The minutes of the meeting or a certified copy of the minutes shall be available at the Company's office no later than two weeks after the shareholders' meeting. Minutes of meetings shall be preserved securely.

Recorded minutes shall be conclusive proof of what has taken place at meetings.

### Article 17

Each króna of share capital shall entitle the owner to one vote at shareholders' meetings.

A majority of votes shall determine the outcome at shareholders' meetings, unless otherwise provided for by national law or these Articles. In the case of a tied election or vote, the motion shall be considered rejected. Voting and election shall be by secret ballot if any of the voting shareholders attending the meeting so demands.

The agreement of all shareholders must be obtained in order to:

1. oblige shareholders to contribute funds etc. for Company purposes, in excess of their obligations;
2. oblige shareholders to be subject to redemption of their shares in part or in full beyond the provisions of statutory law, unless the Company is dissolved or its share capital lawfully written down;
3. alter the purpose of the Company to a substantial extent; and
4. amend the provisions of these Articles regarding voting rights or shareholder equality.

# Chapter IV

## Board of Directors

### Article 18

The Company's Board of Directors shall consist of seven persons and two alternates. The Chairman of the Board of Directors shall be elected individually but the Board divides responsibility for other tasks between its members. Elections to the Board shall as a rule be by secret ballot if the number of nominations exceeds the number of Members to be elected.

In electing members to the Board, the aim shall be to ensure a gender balance and that the Board as a whole possesses in-depth knowledge of banking activities.

The term of office of members of the Board of Directors shall be one year.

**Article 19**

The Chairman shall call Board meetings and direct them. A meeting shall be held whenever the Chairman deems it necessary. In addition, the Chairman is obliged to call a meeting of the Board of Directors if one of the directors or the CEO so requests. Board meetings shall be called with at least 24 hours' notice. It shall constitute a quorum if a majority of the Board members, or their alternates, are in attendance. Questions shall be decided by a majority of votes. In the case of a tie, the Chairman's vote shall determine the outcome.

The Board of Directors shall have minutes taken of Board meetings and attest them with their signatures.

**Article 20**

The Board of Directors shall be ultimately responsible for the Company's activities, as provided for in the relevant legislation, rules and the Articles of Association, and shall supervise its operations.

The Board shall adopt its own rules of procedure, providing in detail for the implementation of its tasks. These rules shall discuss in particular the authorisation of the Board of Directors to take decisions on individual dealings, the implementation of rules on special eligibility of directors, handling of information on individual customers by the Board, participation of directors in the Boards of subsidiaries and affiliated companies, and the implementation of rules on handling business dealings with directors. These rules of procedure must be forwarded to the Financial Supervisory Authority, cf. the second paragraph of Article 54 of Act No. 161/2002, on Financial Undertakings.

Only the Board of Directors may grant authority to sign for the Company. The Board of Directors, acting on a proposal from the Company's CEO, shall adopt Rules on Signatures which shall set out employees' authority to oblige the Company.

# Chapter V

## CEO

**Article 21**

The Chief Executive Officer (CEO) of the Company shall, in accordance with the Act on Financial Undertakings, be authorised to sign for the Company and oblige it. The Board of Directors shall engage the CEO and determine their number and terms of employment in accordance with law. CEO shall meet all qualifications currently provided for by the Act on Financial Undertakings and the Limited Companies Act.

The Board of Directors shall approve the appointment of a deputy CEO, in accordance with a proposal from the CEO. The Board of Directors shall adopt rules on the division of tasks between the Board of Directors and the CEO, in accordance with provisions of the Act on Limited Companies, No. 2/1995, cf. the first paragraph of Article 54 of Act No. 161/2002, on Financial Undertakings and these Articles of Association.

The CEO shall attend meetings of the Board of Directors, unless the Board decides otherwise. The CEO shall implement decisions taken by majority at meetings of the Board of Directors.

The CEO shall be in charge of the Company's day-to-day operations and is authorised to oblige it. The CEO takes decisions on the authority of individual employees to oblige the Company in accordance with rules set by the Board, cf. Article 20. He/She represents the Board in all matters concerning regular operations. The CEO shall consult with the Board on all unusual and material arrangements.

The CEO shall be responsible for record keeping and hiring of staff. The CEO shall provide members of the Board and auditors with all information concerning Company operations which they may request and are entitled to by law.

# CHAPTER VI

## Accounts and auditing

### Article 22

At the Annual General Meeting, a certified public accountant or accounting company shall be elected as the Company's auditor for one year at a time. The Auditor shall examine the Company's accounts and all the accounting documents for each year of operation and shall have access to all the Company's records and documents for such purpose.

The Auditor shall meet all the qualifications currently provided for by law.

### Article 23

The Company's accounting year shall be the calendar year. The Board of Directors and CEO shall prepare the annual financial statements and the annual report each year. The annual financial statements and annual report shall form a single document.

The annual financial statements shall be compiled in accordance with laws, regulations and good accounting practice, both with regard to assessments of various items, structure, breakdown, notes and terminology.

### Article 24

The auditor shall audit the Company's annual financial statements as provided for by law and generally accepted auditing standards. Following the audit, the auditor shall attest to the annual financial statements; such attestation shall accompany the accounts as his report. The annual financial statements and the Auditor's report shall be available for inspection by shareholders for at least one week before the Annual General Meeting.

The audited annual financial statements shall be sent to the Financial Supervisory Authority no later than three months after the end of the accounting year.

In other respects, the provisions of this Chapter shall apply to the Company's consolidated accounts as appropriate.

# CHAPTER VII

## Miscellaneous provisions

### Article 25

These Articles may be amended by a legally constituted AGM or extraordinary general meeting by a majority of 2/3 of votes cast, and by agreement of shareholders controlling at least 2/3 of the Company's share capital represented by the voting rights at the meeting, at least half of shareholders being represented and provided no other majority is specified in the Articles or by national law.

Motions for amendments to the Articles of Association must be mentioned in the announcement of the shareholders' meeting that is to discuss them.

### Article 26

Proposals for the winding up or termination or merger of the Company with other companies shall be addressed at an AGM or extraordinary general meeting, this item on the agenda of the meeting having been specified in its announcement. For a motion proposing the winding up or termination of the Company to be valid, the votes of shareholders controlling at least 2/3 of the total share capital of the Company are required.

A shareholders’ meeting, which has taken a legal decision on the winding up or liquidation of the Company, shall also decide on the disposal of its assets and payment of debts in accordance with current laws.

### Article 27

Unless provided for in these Articles, the provisions of the Act on Public Limited Companies, currently Act No. 2/1995, shall apply with subsequent amendments, as well as provisions of other applicable laws.

Thus adopted at the Annual General Meeting of the Company, 17 April 2013.

This is a translation of the authoritative Icelandic text. In the event of any discrepancies between the translation and the original Icelandic text, the original text shall prevail.