# Consolidated Financial Statements

2014

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# Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. (the "Bank" or "Landsbankinn") for the financial year 2014 include the Bank and its subsidiaries (collectively referred to as the "Group").

Landsbankinn was founded on 7 October 2008. The Bank is a leading bank in the domestic market and offers a complete range of financial products and services to personal, corporate and institutional customers.

### Operations in 2014

Consolidated profit amounted to ISK 29,737 million for the financial year 2014. The Board of Directors will propose to the Annual General Meeting that ISK 1.00 dividend per outstanding share will be paid to shareholders, corresponding to ISK 23,687 million or 80% of the consolidated profit. Remaining profit will be added to the Bank's equity. Consolidated total equity amounted to ISK 250,803 million and total assets amounted to ISK 1,098,370 million at the end of the year. The capital adequacy ratio of the Group, calculated according to the Act on Financial Undertakings, was 29.5% at year-end 2014 (see Note 45).

The carrying amount of loans and advances to customers increased by 5.6% during the year, to ISK 718,355 million from ISK 680,468 million, predominately due to increased mortgage lending. Mortgages now account for roughly 22.9% of loans and advances at year-end 2014 versus 18.4% at year-end 2013. As a result of a successful completion of restructuring of loans and advances acquired at deep discount and improved credit risk management, net valuation adjustments and credit impairment charges were positive by ISK 20,128 million for the year.

On 4 December 2014, an agreement between the Bank and the Winding-up Board of LBI hf. to extend the repayment schedule of the secured foreign currency bonds issued by the Bank to LBI hf. became effective (see Note 30). The agreement is an important step towards further strengthening the Bank's foreign currency financing and should facilitate the Bank's efforts to access debt financing in international capital markets at favourable terms. Furthermore, the agreement marks a significant step towards the easing of capital controls in Iceland.

In October 2014, the international rating agency Standard and Poor's (S&P) revised the outlook for Landsbankinn from stable to positive, and affirmed its long and short-term credit ratings at 'BB+/B'. The revision reflects S&P's view of improving economic conditions in Iceland, supported by expected strong real GDP growth, decreasing government debt and increasing quality of the Bank's assets. The sovereign and banking sector ratings nevertheless continue to be constrained by the risks associated with the removal of capital controls. S&P assumes that the removal will be approached prudently to minimize the impact on the economy and the exchange rate. In its rating, S&P also anticipated that the agreement between the Bank and the Winding-up Board of LBI hf., to extend the repayment profile of the Bank's secured bonds, would come into effect.

In August 2014, the Bank's base prospectus for the issue of foreign currency notes was approved by the Dublin Stock Exchange in Ireland. Subsequently, the Bank listed a Euro Medium Term Note (EMTN) programme on the Irish Stock Exchange. This EMTN programme enables the Bank to issue notes in the equivalent amount of up to EUR 1,000 million in various currencies and at fixed or floating interest rates. Deutsche Bank served as arranger of this EMTN programme. Listing a note programme on a foreign stock exchange puts the Bank in a position to issue foreign currency notes, should favourable terms become available.

In April 2014, the Bank opened a specialised Corporate Service Centre for corporates and the capital city region's small and medium-sized enterprises (SMEs). This arrangement provides corporate and SMEs in the capital city region with access to higher quality and more comprehensive expert services in one place. Other branches in the capital city region will be dedicated to personal banking and basic services to corporates. These changes are intended to improve quality of service to individuals and corporates alike and increase the operational efficiency of the Bank's customer service.

In 2014, the Bank sold all of its shares in the payment card companies Borgun hf. and Valitor Holding hf., as well as all of its shares in IEI slhf. and a 9.9% shareholding in Icelandic Enterprise Investment Fund slhf. As a result, the carrying amount of investments in equity-accounted associates have been reduced from ISK 14,224 million at year-end 2013 to ISK 777 million at year-end 2014 (see Note 23).

In 2014, the Bank continued to issue tranches in Landsbankinn's non-indexed covered bond series. New series LBANK CB 17 and LBANK CB 19 were added to the coexisting series LBANK CB 16 during the year. All of the series have been admitted for trading on NASDAQ QMX Iceland and the total amount of issued covered bonds at year end 2014 is ISK 7,470 million. The covered bond issues provide broader funding opportunities for the Bank's mortgage portfolio and reduce the Bank's fixed interest rate risk (see Note 30).

Amongst the open material litigation cases disclosed at year-end 2014 in the litigation section in Note 35, some may have a greater impact on the amounts disclosed in the Group's Financial Statements than others. The cases of greatest importance relate, on the one hand, to recalculation of foreign currency indexed loans and, on the other, to the inflation-indexation of financial obligations. In the former, the comparative position between the Bank against the customer and the disruptive impact on the corporate customer's financial position are being disputed. In the latter, the legitimacy of information disclosure by the Bank and consumer price indexation provisions of financial obligations is being disputed. The EFTA Court submitted its advisory opinion on the latter without decisive conclusions, leaving final judgment in the hands of the national courts. In February 2015, the Reykjavik District Court, in two comparable cases, rejected the argument that provisions on consumer price indexation of loan agreements should be declared null and void.

### Risk management

The Bank's core operations are sound and have been improving in recent years. Processes are being revised on a continuous basis to improve risk management, efficiency and customer relationship management. As a result of improved credit risk management, the ratio of non-performing loans has decreased steadily since the beginning of the year 2014 and borrower credit quality has strengthened in the fourth quarter of 2014. The improved position is evidenced by the decreasing number of borrowers on watch lists.

The Group's liquidity position is strong in both ISK and foreign currencies, and liquidity ratios are well above minimum regulatory requirements. The Bank's leverage and funding ratios are also strong and well above minimum requirements. The Bank is well positioned to meet additional capital requirements, as forthcoming Icelandic legislation, implementing the new EU Capital Requirements Directive (CRD IV), is expected to require the Bank to hold capital buffers in addition to existing capital requirements. The Bank has set a target for a total capital ratio of at least 20% of risk-weighted assets (see Note 44), which is over and above legal and regulatory requirements.

### Outlook

Preliminary estimates from Statistics Iceland suggest that annual gross domestic product (GDP) growth was just 0.5% for the first three quarters of 2014. Domestic demand, however, grew by 3%, thereof consumption and investment by 3.9%. Landsbankinn Economic Research expects strong GDP growth in Q4 and an upward revision of the preliminary figures for Q1-Q3. With that in mind, GDP growth for 2014 is expected to have been significantly stronger than preliminary figures suggest. The outlook for 2015 is favourable; GDP is expected to grow by 4.3%.

The sharp year-over-year income increase in Net valuation adjustments and credit impairment charges is largely attributed to the increased quality of the loan portfolio. This increase is to a large extent offset by decreased Net interest income, Other net operating income and Share of profit of equity accounted associates. The decrease in Net interest income is greatly due to a sharp and unexpected decrease in inflation. The net valuation adjustments, plus increased taxation of the Bank, have a considerable effect on the total net profit and are factors that need to be considered in terms of the Bank's future profitability. Excluding Net valuation adjustments, the Bank's cost efficiency ratio rose to 56.0%, which is above the target range. This was due to a reduction in net interest income and other net operating income, higher staff costs and investment in strategic initiatives. The Bank has reviewed its strategy with the aim to improve sustainable profitability in the future.

### Other matters

In the fourth quarter of 2014, the Bank made a prepayment of principal of the secured foreign currency bonds equivalent to ISK 30,000 million in total. The Bank's strong liquidity position in foreign currencies has enabled the Bank to reduce its foreign currency liabilities by making significant early repayments on the bonds in recent years.

On 26 March 2014, the Bank paid dividends for the operating year 2013 to its shareholders in accordance with a resolution passed at the Bank's Annual General Meeting held on 19 March 2014. The dividend payment amounted to ISK 19,897 million, equivalent to ISK 0.84 per share for the year 2013, or 70% of net profit for the year 2013.

In February 2014, the Bank completed the allocation of own shares received from LBI hf. in 2013, in accordance with the requirements of LBI hf. and a resolution passed at a shareholders' meeting of the Bank in July 2013. The net result of the 500 million shares being allocated, and partly repurchased by the Bank for settlement of tax obligations and pension liabilities, is that the Bank's current and former employees now own 187 million shares in total (0.78%) and the Bank itself holds 313 million of own shares (1.30%).

### Ownership

The total number of shareholders at year-end 2014 was 1,403, up from 1,394 at the beginning of 2014. The ten largest shareholders in the Bank at year-end 2014 are as follows:

| Shareholders | | Number of shares (in ISK million) | % |
|---|---|---|---|
| Ríkissjóður Íslands | Icelandic State Treasury | 23,500.0 | 97.92% |
| Helgi T. Helgason | Employee of Landsbankinn hf. | 0.5 | 0.00% |
| Hreiðar Bjarnason | Employee of Landsbankinn hf. | 0.5 | 0.00% |
| Árni Þ. Þorbjörnsson | Employee of Landsbankinn hf. | 0.5 | 0.00% |
| Helgi Þ. Arason | Employee of Landsbréf hf. | 0.4 | 0.00% |
| Hermann M. Þórisson | Employee of Landsbréf hf. | 0.4 | 0.00% |
| Guðni Einarsson | Employee of Landsbankinn hf. | 0.4 | 0.00% |
| Sigrún Sæmundsdóttir | Employee of Landsbankinn hf. | 0.4 | 0.00% |
| Davíð Björnsson | Employee of Landsbankinn hf. | 0.4 | 0.00% |
| Einar K. Jónsson | Employee of Landsbankinn hf. | 0.4 | 0.00% |
| **Top 10 total** | | **23,504.0** | **97.93%** |
| Other shareholders | | 183.1 | 0.76% |
| **Total shares outstanding** | | **23,687.1** | **98.70%** |
| Landsbankinn hf. | Own shares | 312.9 | 1.3% |
| **Total shares issued** | | **24,000.0** | **100.00%** |

Icelandic State Financial Investments (ISFI) manages the State's holding in the Bank on behalf of Ríkissjóður Íslands (the Icelandic State Treasury).

### Governance

The Bank's good governance practices form the foundation for trust in the interrelationship between shareholders, Board of Directors, management, employees and interested parties, and they promote objectivity, integrity, transparency and responsibility in the management of the Bank.

Each year, the Bank reviews compliance with generally accepted guidelines on corporate governance and whether the Bank's governance practices are in accordance with those guidelines at all times.

The underlying regulatory framework for the Bank's corporate governance policy and procedures is comprised of, inter alia, the Act on Financial Undertakings No. 161/2002 and subsequent amendments (No. 75/2010), the Act on Annual Financial Statements No. 3/2006 and subsequent amendments (No. 118/2011), as well as other applicable laws and regulations.

Landsbankinn complies with the recommendations of the most recent Corporate Governance Guidelines issued in March 2012 (fourth edition) by the Iceland Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers, except for certain items in Articles 1.1, 2.7, 5.B.3 and 5.B.4 in the Guidelines. Further details on the Bank's corporate governance in general and these exceptions are provided in the Annual Report of the Group for the year 2014 and on the Bank's website www.landsbankinn.is.

In December 2014, the Bank was recognised as a model of good corporate governance following a formal review of the work procedures of its Board and executives. The review was performed by the Centre of Corporate Governance of the University of Iceland and was based on the Corporate Governance Guidelines. The review is performed under a co-operative agreement between the Centre of Corporate Governance and the Iceland Chamber of Commerce, NASDAQ OMX Iceland and the Confederation of Icelandic Employers.

### Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Landsbankinn hf. for the year ended 31 December 2014 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 2014, its consolidated financial position as at 31 December 2014 and its consolidated cash flows for the year 2014.

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 2014 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, 26 February 2015.

Board of Directors

Tryggvi Pálsson

Chairman

Danielle Pamela Neben

Eva Sóley Guðbjörnsdóttir

Helga Björk Eiríksdóttir

Jóhann Hjartarson

Jón Sigurðsson

Kristján Þ. Davíðsson

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 31 December, 2014, 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.

### The Board of Directors and CEO's Responsibility for the Consolidated Financial Statements

The Board of Directors and CEO are 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 they determine 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 judgement, including the assessment of the risks of material misstatement of the Consolidated 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 policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated 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, 2014, 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 104, Paragraph 2 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 Consolidated Financial Statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Consolidated Financial Statements.

Reykjavík, 26 February 2015.

***KPMG ehf.***

Helgi F. Arnarson

Sigríður Helga Sveinsdóttir

## Consolidated Income Statement for the Year ended 31 December 2014

| Notes | | 2014 | 2013 |
|---|---|---|---|
| | Interest income | 53,735 | 63,224 |
| | Interest expense | (25,662) | (28,910) |
| 6 | **Net interest income** | **28,073** | **34,314** |
| | | | |
| 7 | Net valuation adjustments and credit impairment charges | 20,128 | 13,053 |
| | **Net interest income after net valuation adjustments and credit impairment charges** | **48,201** | **47,367** |
| | | | |
| | Fee and commission income | 7,737 | 8,451 |
| | Fee and commission expense | (1,901) | (3,160) |
| 8 | **Net fee and commission income** | **5,836** | **5,291** |
| | | | |
| 9 | Net gain on financial assets designated as at fair value through profit or loss | 5,300 | 8,460 |
| 10 | Net gain on financial assets and liabilities held for trading | 1,463 | 2,092 |
| 12 | Net foreign exchange gain(loss) | 67 | 1,147 |
| 13 | Other income and (expenses) | 2,282 | 1,224 |
| | **Other net operating income** | **9,112** | **12,923** |
| | **Total operating income** | **63,149** | **65,581** |
| | | | |
| 14 | Salaries and related expenses | 13,567 | 17,304 |
| 15 | Other operating expenses | 8,545 | 8,050 |
| 24 | Depreciation and amortisation | 942 | 818 |
| 32 | Contribution to the Depositors' and Investors' Guarantee Fund | 1,034 | 1,079 |
| | **Total operating expenses** | **24,088** | **27,251** |
| | | | |
| 23 | Share of profit of equity-accounted associates | 465 | 2,712 |
| | **Profit before tax** | **39,526** | **41,042** |
| | | | |
| 16 | Income tax | (6,821) | (9,000) |
| 16 | Tax on liabilities of financial institutions | (2,968) | (3,283) |
| | **Profit for the year** | **29,737** | **28,759** |
| | | | |
| | **Profit for the year attributable to:** | | |
| | **Owners of the Bank** | | |
| | Profit for the year from continuing operations | 29,737 | 28,750 |
| | **Profit for the year attributable to owners of the Bank** | **29,737** | **28,750** |
| | | | |
| | **Non-controlling interests** | | |
| | Profit for the year from continuing operations | 0 | 9 |
| | **Profit for the year attributable to non-controlling interests** | **0** | **9** |
| | **Profit for the year** | **29,737** | **28,759** |
| | | | |
| | **Earnings per share:** | | |
| 34 | Basic and diluted earnings per share from continuing operations | **1.26** | **1.22** |
| | **Total basic and diluted earnings per share** | **1.26** | **1.22** |

The accompanying notes are an integral part of these Consolidated Financial Statements.

## Consolidated Statement of Financial Position as at 31 December 2014

| Notes | | 2014 | 2013 |
|---|---|---|---|
| | **Assets** | | |
| 18 | Cash and balances with Central Bank | 10,160 | 21,520 |
| 17,19,77 | Bonds and debt instruments | 243,589 | 290,595 |
| 19 | Equities and equity instruments | 29,433 | 36,275 |
| 17,20 | Derivative instruments | 78 | 654 |
| 21,77 | Loans and advances to financial institutions | 49,789 | 67,916 |
| 22,77 | Loans and advances to customers | 718,355 | 680,468 |
| 23 | Investments in equity-accounted associates | 777 | 14,224 |
| 24 | Property and equipment | 5,691 | 5,440 |
| 25 | Intangible assets | 1,225 | 585 |
| 31 | Deferred tax assets | 83 | 0 |
| 26 | Other assets | 20,978 | 8,816 |
| | | **1,080,158** | **1,126,493** |
| 27 | Assets classified as held for sale | 18,212 | 25,023 |
| | **Total assets** | **1,098,370** | **1,151,516** |
| | **Liabilities** | | |
| 28 | Due to financial institutions and Central Bank | 53,827 | 167,218 |
| 29 | Deposits from customers | 551,435 | 456,662 |
| 20 | Derivative instruments and short positions | 5,409 | 7,571 |
| 30,77 | Secured bonds | 207,028 | 239,642 |
| 31 | Deferred tax liabilities | 0 | 590 |
| 32 | Other liabilities | 27,034 | 34,589 |
| | | **844,733** | **906,272** |
| | Liabilities associated with assets classified as held for sale | 2,834 | 3,885 |
| | **Total liabilities** | **847,567** | **910,157** |
| 33 | **Equity** | | |
| | Share capital | 23,687 | 23,618 |
| | Share premium | 121,275 | 120,700 |
| | Reserves | 6,000 | 7,046 |
| | Retained earnings | 99,841 | 90,002 |
| | **Total equity attributable to owners of the Bank** | **250,803** | **241,366** |
| | Non-controlling interests | 0 | (7) |
| | **Total equity** | **250,803** | **241,359** |
| | **Total liabilities and equity** | **1,098,370** | **1,151,516** |

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Consolidated Statement of Changes in Equity for the Year ended 31 December 2014

| Notes | | Attributable to owners of the Bank | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Change in equity for the year 2014** | **Share capital** | **Share premium** | **Own shares reserve** | **Statutory reserve** | **Share-based payment reserve** | **Retained earnings** | **Total** | **Non-controlling interests** | **Total** |
| | Balance at 1 January 2014 | 23,618 | 120,700 | | 6,000 | 1,046 | 90,002 | 241,366 | (7) | 241,359 |
| | Profit for the year | | | | | | 29,737 | 29,737 | 0 | 29,737 |
| | Own shares allocated to employees | 112 | 934 | | | (1,046) | | 0 | | 0 |
| | Purchase of own shares for settlement of tax obligations and pension liabilities | (43) | (359) | | | | | (402) | | (402) |
| | Dividends paid | | | | | | (19,897) | (19,897) | | (19,897) |
| | Change in non-controlling interests due to sale of subsidiaries | | | | | | | 0 | 7 | 7 |
| 33 | **Balance at 31 December 2014** | **23,687** | **121,275** | **0** | **6,000** | **0** | **99,841** | **250,803** | **0** | **250,803** |
| | | | | | | | | | | |
| | **Change in equity for the year 2013** | | | | | | | | | |
| | Balance at 1 January 2013 | 24,000 | 123,898 | | 5,053 | | 72,120 | 225,071 | 95 | 225,166 |
| | Profit for the year | | | | | | 28,750 | 28,750 | 9 | 28,759 |
| | Equity classified as liability to purchase own shares | | | (4,691) | | | | (4,691) | | (4,691) |
| | Purchase of own shares | (500) | (4,191) | 4,691 | | | | 0 | | 0 |
| | Recognition of equity-settled employee share-based payments | | | | | 4,017 | | 4,017 | | 4,017 |
| | Dividends paid | | | | | | (9,921) | (9,921) | | (9,921) |
| | Own shares allocated to employees | 317 | 2,654 | | | (2,971) | | 0 | | 0 |
| | Purchase of own shares for settlement of tax obligations and pension liabilities | (199) | (1,661) | | | | | (1,860) | | (1,860) |
| | Transfer to statutory reserve | | | | 947 | | (947) | 0 | | 0 |
| | Decrease in non-controlling interests due to sale of subsidiaries | | | | | | | 0 | (111) | (111) |
| 33 | **Balance at 31 December 2013** | **23,618** | **120,700** | **0** | **6,000** | **1,046** | **90,002** | **241,366** | **(7)** | **241,359** |

The accompanying notes are an integral part of these Consolidated Financial Statements.

# Consolidated Statement of Cash Flows for the Year ended 31 December 2014

| Notes | | 2014 | 2013 |
|---|---|---|---|
| | **Operating activities** | | |
| | Profit for the year | 29,737 | 28,759 |
| | Adjustments for non-cash items included in profit for the year | (48,504) | (45,393) |
| | Changes in operating assets and liabilities | 50,935 | 39,532 |
| | Interest received | 46,041 | 43,205 |
| | Interest paid | (25,793) | (26,026) |
| 11 | Dividends received | 1,345 | 425 |
| | Income tax and special tax on financial institutions paid | (10,907) | (49) |
| | **Net cash from (used in) operating activities** | **42,854** | **40,453** |
| | **Investing activities** | | |
| | Proceeds of shares in equity-accounted associates | 13,580 | 4,833 |
| 24 | Purchase of property and equipment | (1,253) | (820) |
| 24 | Proceeds from sale of property and equipment | 171 | 1,152 |
| 25 | Purchase of intangible assets | (791) | (293) |
| | Sale of subsidiaries | 0 | 1,067 |
| | **Net cash from investing activities** | **11,707** | **5,939** |
| | **Financing activities** | | |
| | Proceeds from new long-term debt issue | 5,420 | 1,860 |
| | Aquisition of non-controlling interest | 0 | 840 |
| | Repayment of secured bonds | (43,325) | (52,201) |
| 33 | Dividends paid | (19,897) | (9,921) |
| | **Net cash used in financing activities** | **(57,802)** | **(59,422)** |
| | Net change in cash and cash equivalents | (3,241) | (13,030) |
| | Cash and cash equivalents as at the beginning of the year | 19,927 | 32,486 |
| | Effect of exchange rate changes on cash and cash equivalents held | (98) | 471 |
| | **Cash and cash equivalents as at 31 December** | **16,588** | **19,927** |

The accompanying notes are an integral part of these Consolidated Financial Statements.

## Consolidated Statement of Cash Flows for the Year ended 31 December 2014

| Notes | | 2014 | 2013 |
|---|---|---|---|
| | **Adjustments for non-cash items included in profit for the year** | | |
| 6 | Net interest income | (28,073) | (34,314) |
| 7 | Net adjustments to loans and advances acquired at deep discount | (20,010) | (19,440) |
| 7,66 | Net impairment loss | 2,038 | 7,706 |
| 7 | Reversals of loss from foreign currency linkage of loans and advances to customers | (2,156) | 0 |
| 17,30 | Fair value change of contingent bond | 0 | (1,319) |
| 9 | Net (gain) on financial assets designated as at fair value through profit or loss | (5,300) | (8,460) |
| 10 | Net (gain) on financial assets and liabilities held for trading | (1,463) | (2,092) |
| 12 | Net foreign exchange loss (gain) | 31 | (1,618) |
| 24 | Loss (gain) on sale of property and equipment | 40 | (277) |
| 13 | Loss on repossessed collateral | 41 | 177 |
| 24 | Depreciation and amortisation | 942 | 818 |
| 23 | Share of profit of equity-accounted associates | (465) | (2,712) |
| | Profit of sale of associates | (3,918) | (836) |
| 33 | Recognition of equity-settled employee share-based payments | 0 | 4,691 |
| 16 | Income tax | 6,821 | 9,000 |
| 16 | Tax on liabilities of financial institutions | 2,968 | 3,283 |
| | | **(48,504)** | **(45,393)** |
| | **Changes in operating assets and liabilities** | | |
| | Change in reserve requirement with Central Bank | (241) | (4,485) |
| | Change in bonds and equities | 69,377 | (57,214) |
| | Change in derivatives | 142 | 0 |
| | Change in loans and advances to financial institutions | 26,240 | (10,949) |
| | Change in loans and advances to customers | 708 | (3,698) |
| | Change in other assets | (10,600) | 5,768 |
| | Change in assets classified as held for sale | 1 | 4,150 |
| | Change in due to financial institutions and Central Bank | (2,943) | 69,502 |
| | Change in deposits from customers | (19,022) | 42,389 |
| | Change in tax liability | (673) | (383) |
| | Change in repossessed collateral | 4,357 | 712 |
| | Change in other liabilities | (10,127) | (5,019) |
| | Change in liabilities associated with assets classified as held for sale | (6,284) | (1,241) |
| | | **50,935** | **39,532** |
| | **Cash and cash equivalents is specified as follows:** | | |
| 18 | Cash and unrestricted balances with Central Bank | 3,463 | 15,064 |
| 21 | Bank accounts with financial institutions | 13,125 | 4,863 |
| | **Cash and cash equivalents as at the end of the year** | **16,588** | **19,927** |

The accompanying notes are an integral part of these Consolidated Financial Statements.

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| 6 | Net interest income | 27 |
| 7 | Net valuation adjustments and credit impairment charges | 27 |
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# Notes to the Consolidated Financial Statements

## 1. Reporting entity

Landsbankinn hf. (hereinafter referred to as the "Bank" or "Landsbankinn") was founded on 7 October 2008. The Bank is a limited liability company incorporated and domiciled in Iceland. The Bank operates in accordance with Act No. 161/2002. 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 2014 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, markets, 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 26 February 2015.

## 2. Basis of preparation

### Statement of compliance

These Consolidated Financial Statements for the year ended 31 December 2014 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 *króna* (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 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 2013.

The principal accounting polices used in preparing these Consolidated Financial Statements are set out in notes 3.1 to 3.35

## 3. Significant accounting policies (continued)

### 3.1 Consolidation

#### (a) Subsidiaries

Subsidiaries are investees controlled by the Group. The Group controls an investee if it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. The Group is considered to have power over an entity when it has existing rights that give it the current ability to direct the relevant activities. For the Group to have power over an entity, it must have the practical ability to exercise those rights.

Where voting rights are not relevant in deciding whether the Group has power over an entity, the assessment of control is based on all facts and circumstances. This includes circumstances in which protective rights held become substantive and lead to the Group having power over an investee.

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.

#### (c) Loss of control

When the Group loses control over a subsidiary, it derecognises the assets and liabilities of the subsidiary, related non-controlling interests and other components of equity. Any resulting gain or loss is recognised in the income statement. Any interest retained in the former subsidiary is measured at fair value when control is lost.

### 3.2 Structured entities

Structured entities are entities that have been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The Group acts as investment manager or investment advisor to a number of investment funds for Landsbréf-branded funds. The purpose of these investment funds is to generate fees from managing assets on behalf of third-party investors by providing investment strategies. These investment funds are financed through the issue of units to investors. The Group has no contractual obligation to provide financial support to these structured entities.

From time to time, the Group makes seed capital investments in certain fund products in order to establish track records for new products, to test new investment strategies or to launch new products at a viable minimum size.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee, and is able to influence the returns of the funds by exercising its power.

## 3. Significant accounting policies (continued)

### 3.3 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.

*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. 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. 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”.

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 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.

### 3.4 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. All foreign currency differences arising on retranslation are recognised in the income statement.

### 3.5 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)

### 3.5 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 price that would be received from the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or, in its absence, the most advantageous market to which the Group has access at that date.

The fair value of a liability reflects its non-performance risk. The fair value of a demand deposit is not less than the amount payable on demand, discounted from the first date on which the amount could be required to be paid.

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 an asset or a liability measured at fair value has a bid price and an ask price, then the Group measures assets and long positions at a bid price and liabilities and short positions at an ask 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)

### 3.5 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:

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

• significant financial difficulties of the borrower or issuer;
• 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;
• 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 valuation 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 valuated 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)

### 3.5 Financial assets and liabilities (continued)

*Renegotiated loans*

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. 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.

### 3.6 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.

### 3.7 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.

### 3.8 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.

### 3.9 Embedded derivatives

Derivatives may be embedded in another contractual arrangement (a host contract). The Group accounts for an embedded derivative separately from the host contract when:

- the host contract is not itself carried at fair value through profit or loss;
- the terms of the embedded derivative would meet the definition of a derivative if they were contained in a separate contract
- the economic characteristics and risk of the embedded derivative are not closely related to the economic characteristics and risk of the host contract.

Separated embedded derivatives are measured at fair value, with all change in fair value recognised in profit or loss unless they form part of a qualifying cash flow or net investment-hedging relationship. Separated embedded derivatives are presented in the statement of financial position together with the host contract.

### 3.10 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 the acquisition date. The deep discount was included in the fair value of these loans and advances estimated at initial recognition. The deep discount was 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.

## 3. Significant accounting policies (continued)

### 3.10 Loans and advances (continued)

At each reporting date, the Group assessed the current status of these loans and advances and whether there was any objective evidence of changes in expected cash flows, for example, due to changes in the value of collateral and improvement in the financial situation of debtors. If there was any change in expected cash flows, the Group recalculated 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 included accrued interest, indexation, foreign exchange differences and actual payments received by the Group, was recognised in the income statement in the line “Net valuation adjustments and credit impairment charges”.

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

As at year end 2014, the restructuring of the loans and advances acquired at deep discount from LBI hf. has been completed. As of year-end 2014 the deep discount will not any longer be a part of the estimated future cash flows used to calculate the amortised cost and effective interest rate of these loans and advances. As a result income statement recognition of net valuation adjustments to these specific loans and advances is discontinued as of year-end 2014. However, impairment allowances on these loans and advances continue to be recognised when there is objective evidence of impairment.

### 3.11 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.

### 3.12 Intangible assets

#### Computer software

Computer software is capitalised on the basis of cost to acquire or develop and bring into service. Computer software recognised as an intangible asset is amortised over its 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.

### 3.13 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.

### 3.14 Income tax

#### (a) Income tax

Income tax is recognised based on the domestic corporate income tax rates and tax laws that have been enacted at the reporting date. Income tax recognised in these Consolidated Financial Statements comprises current and deferred tax.

### 3. Significant accounting policies (continued)

#### 3.14 Income tax (continued)

**(b) Current tax**

Current tax comprises the expected tax payable on the taxable income for the current year and, if applicable, adjustments to the tax payable or receivable in respect of previous years. Current tax is measured based on the domestic corporate income tax rates and tax laws that have been enacted or substantively enacted at the reporting date.

**(c) Deferred 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.

#### 3.15 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 flow methodologies. Costs to sell are deemed to be only the costs which are directly attributable to the disposal of the disposal groups, excluding finance costs and income tax expense.

#### 3.16 Deposits and borrowings

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.

#### 3.17 Secured bonds

The secured bonds consist of secured bonds denominated in foreign currencies which the Bank has issued specifically to LBI hf. and series of marketable covered bonds denominated in ISK which have been issued by the Bank and admitted for trading on NASDAQ OMX Iceland. The secured foreign currency bonds which the Bank issued to LBI hf. as a consideration and an additional consideration for the assets and liabilities transferred from LBI hf. to the Bank on 9 October 2008 consisted originally of bonds issued in October 2010 and April 2013, alias the Original Bonds. The secured bonds issued as an additional consideration were recognised in April 2013 as a financial liability and replaced the contingent obligations under the Contingent Bond, which consequently was derecognised as a financial liability.

## 3. Significant accounting policies (continued)

### 3.17 Secured bonds (continued)

The secured bonds 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 is recognised in the line item "Interest expense" in the income statement. Foreign exchange gains and losses are included in the line item "Net foreign exchange gain (loss)".

### 3.18 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".

### 3.19 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.

### 3.20 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 considerations 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.

### 3.21 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.

### 3.22 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.

#### (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.

### 3.23 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. Significant accounting policies (continued)

### 3.24 Interest income and expense

The interest income, expense and inflation indexation 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.

### 3.25 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 valuation adjustments and credit impairment charges". 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.

### 3.26 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.

### 3.27 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;
• Dividend income, which is recognised when the Group's right to receive payment is established.

### 3.28 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;
• 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 gain" in the income statement.

### 3.29 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.

### 3.30 Other income and expenses

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

## 3. Significant accounting policies (continued)

### 3.31 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.

### 3.32 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;
• 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.

### 3.33 Earnings per share

The Group presents basic and diluted earnings per share data for its ordinary shares. Basic earnings per share is calculated by dividing the profit or loss that is attributable to ordinary shareholders of the Bank by the weighted average number of shares outstanding during the period. The Bank's basic and diluted earnings per share are equal as the Bank has not issued any options, warrants, convertibles or other potential sources of dilution.

### 3.34 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.

### 3.35 New standards, amendments to standards and interpretations of standards

The amendments to IAS 32 Financial Instruments: Presentation, IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities became effective for the year ended 31 December 2014 and have been applied in these Consolidated Financial Statements. IAS 32 requires more extensive disclosure about the effect or potential effect of netting arrangements on the Group's financial position. The adoption of IAS 32 had immaterial effects on the consolidated financial statements of the Group. IFRS 10 outlines the requirements for the preparation and presentation of consolidated financial statements, requiring an entity to consolidate entities it controls. IFRS 12 is a consolidated disclosure standard requiring a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. In other respects, the material effects of standards that have not yet become effective for the year ended 31 December 2014 remain uncertain.

The amendments to IAS 32 and IFRS 7 Offsetting Financial Assets and Financial Liabilities 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 IFRS 7 and IAS 32 became mandatory for the Group starting respectively with the consolidated financial statements for the year 2013 and 2014. Retrospective application is required for both amendments to IAS 32 and IFRS 7. The initial adoption of the amendments to IFRS 7 resulted in a new disclosure, Offsetting financial assets and liabilities (Note 69), whereas the initial adoption of the amendments to IAS 32, requires, inter alia, that the Group provide more extensive disclosure about the effect or potential effect of netting arrangements on the Group's financial position.

## 3. Significant accounting policies (continued)

### 3.35 New standards, amendments to standards and interpretations of standards (continued)

IFRS 10 Consolidated Financial Statements became effective on 1 January 2014 and has been applied in these Consolidated Financial Statements. IFRS 10 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. The adoption of IFRS 10 does not have any impact on the Group's Financial Statements.

IFRS 12 Disclosure of Interests in Other Entities is a consolidated disclosure standard requiring a wide range of disclosures about an entity's 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 IAS 27 Consolidated and Separate Financial Statements, IAS 28 Investment in Associates, and IAS 31 Interests in Joint Ventures. IFRS 12 became mandatory for the Group starting with its Consolidated Financial Statements for the year 2014. The standard requires the Group to provide more extensive disclosures about the nature of, and risks associated with, the Group's interests in other entities and the effects of those interests on the Group's financial position, financial performance and cash flows. The new disclosure requirements are addressed in Notes 38, 39, 40 and 41.

IFRS 9 Financial Instruments, 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 as follows:

• 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 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 at fair value through profit or loss.

In July 2014, the International Accounting Standards Board (IASB) issued the fourth and final version of its new standard on financial instruments accounting, IFRS 9 Financial Instruments. The standard includes revised guidance in the classification and measurement of financial instruments, including a new expected credit loss model for calculating impairment on financial assets, and the new general hedge accounting requirements. It also carries forward the guidance on recognition and derecognition of financial instrument from IAS 39. The standard has a mandatory effective date of 1 January 2018, but may be adopted early. If endorsed by the EU, IFRS 9 will become mandatory for the Group starting with its consolidated financial statements for the year 2018. The Group does not plan to early-adopt IFRS 9 and 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 its consolidated financial statements.

IFRS 15 Revenue from Contracts with Customers establishes a comprehensive framework for determining whether, how much and when revenue is recognized. It replaces existing revenue recognition guidance, including IAS 18 Revenue, IAS 11 Constructions Contracts and IFRIC 13 Customer Loyalty Programmes. IFRS 15 is effective for annual reporting periods beginning on or after 1 January 2017.

## 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 was computed for these loans by estimating their future cash flows and comparing it with their acquisition prices. Estimating the cash flows involved 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 had a significant risk of resulting in material adjustments to the carrying amounts of loans within the next financial year. As at year-end 2014, the restructuring of the loans and advances acquired at deep discount from LBI hf. has been completed. As of year-end 2014 the deep discount will no longer be a part of the estimated future cash flows used to calculate the amortised cost and effective interest rate of these loans and advances.

### (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 of the Group. 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.

### (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) Determination of control over investees

Management applies its judgement to determine whether the control indicators set out in Note 3.1 Consolidation, indicate that the Group controls a investment fund.

The Group acts as fund manager to a number of investment funds. When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or a guarantee, and is able to influence the returns of the funds by exercising its power.

For further disclosure in respect of unconsolidated investment funds in which the Group acts as an agent see Note 40 Unconsolidated structured entities.

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

### (g) 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.

### (h) Foreign currency indexed loans and inflation-indexation of financial obligations

Amongst the open material litigation cases disclosed at year-end 2014 in the litigation section in Note 35, some may have a greater impact on the amounts disclosed in the Group's Financial Statements than others. The cases of greatest importance relate to recalculation of foreign currency indexed loans and the inflation-indexation of financial obligations.

In 2014, the Bank continued to correct recalculations of loans which fall under the precedent of the Supreme Court's rulings on foreign currency indexation, where the substance of loan contracts and retroactive calculations under certain circumstances were disputed. At year-end 2014, the Supreme Court's ruling was being awaited on one of these issues in litigation brought against the Bank by a corporate customer. In this particular case, the comparative position between the Bank and the customer and the disruptive impact on the corporate customer's financial position are being disputed. The District Court has ruled in favour of the Bank, rejecting the argument that the customer was in a comparatively weaker position than the Bank and the argument that the customer's financial position would be disrupted. This case may set a precedent for other foreign currency indexed loans to corporate customers where circumstances are identical and may have a considerable impact on the Group's Consolidated Income Statement in the forthcoming periods. If the Supreme Court's ruling in this case and other similar cases will not be favourable for the Bank, the Bank may have to recognise expenses in the amount of up to ISK 5,707 million. Conversely, if all such rulings will be favourable for the Bank, the Bank will recognise considerable income.

In November 2014, the EFTA Court submitted its advisory opinion, as requested by the District Court, in litigation brought by a personal customer against the Bank who disputed the legitimacy of information disclosure and consumer price indexation provisions of a bond issued by the customer to the Bank. The EFTA Court found that it is for the national court to assess, taking account of all the circumstances of the case, the legal consequences of and the remedies for providing information on the total cost of the credit and the annual percentage rate of charge that is not compatible with Directive 87/102/EEC, on Consumer Credit. Furthermore, the EFTA Court found that Directive 93/13/EEC on Unfair Terms in Consumer Contracts does not generally prohibit contractual terms on the indexation of loans in contracts between a lender and a consumer. It is for the national court to assess whether the terms are unfair. The District Court will now review the EFTA Court's opinion and establish, based on Icelandic law, whether and to what extent it impacts judgement in the case. In February 2015, the Reykjavik District Court ruled in two cases against separate financial institutions, in which similar issues were disputed, that it had not been established that information disclosure to the borrower had impacted the borrowers' interests to such an extent as to nullify the consumer price indexation provisions. If the ruling in the Bank's case is unfavourable for the Bank, it may set a precedent for other financial obligations issued by customers where circumstances are identical and may have a significant impact on the amounts disclosed in the Group's Financial Statements. It is unclear when a final ruling might be expected in this case.

## 5. Operating segments

Business segments are presented in accordance with 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.

In April 2014, the Bank opened a specialised Corporate Service Centre for small and medium-sized enterprises (SMEs) located in the capital city region. As a result, services to these SMEs have shifted from the Personal to the Corporate Banking division. At the end of the reporting period, the Group continues as before with its four main business segments.

• **Personal Banking** provides financial services through the Bank's branch network to individuals and to small and medium-size businesses outside the capital city region.

• **Corporate Banking** provides financial services to corporate clients and to small and medium-size businesses in the capital city region. It also provides restructuring solutions for underperforming businesses.

• **Markets** provide brokerage services in securities, foreign currencies and derivatives, securities offerings and advisory services. Markets also do market making for listed securities and foreign currencies. Markets provide a range of wealth and asset management products and services for individuals, corporations and institutional investors. Landsbréf hf., a subsidiary of the Bank, is included in Markets as an operating segment.

• **Treasury** incorporates the Bank's funding and liquidity management and market making in money markets and determines the Bank's internal pricing. Treasury also manages the Bank's exchange rate, interest rate and inflation risks, within limits that are set by the Board of Directors. The Bank allocates capital to the operating segments based on the Bank's target for a total capital ratio of at least 20%, but all capital over and above the minimum target is allocated to Treasury.

Support functions are comprised 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 segment profits 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 2014 and 2013.

## 5. Operating segments (continued)

| 1 January - 31 December 2014 | Personal Banking | Corporate Banking | Markets | Treasury | Support functions | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 14,820 | 15,704 | 772 | (1,984) | 5 | (1,244) | **28,073** |
| Net credit impairment charges and valuation adjustments | 8,985 | 9,214 | - | (54) | 1,983 | - | **20,128** |
| Net fee and commission income | 2,785 | 646 | 3,061 | (322) | 83 | (417) | **5,836** |
| Other net operating income | 440 | (264) | 359 | 9,311 | (1,819) | 1,085 | **9,112** |
| **Total operating income (expense)** | **27,030** | **25,300** | **4,192** | **6,951** | **252** | **(576)** | **63,149** |
| Operating expenses | (6,323) | (1,558) | (2,050) | (1,369) | (13,225) | 437 | **(24,088)** |
| Share of profit (loss) of equity-accounted associates | 444 | - | - | (45) | 66 | - | **465** |
| **Profit (loss) before cost allocation and tax** | **21,151** | **23,742** | **2,142** | **5,537** | **(12,907)** | **(139)** | **39,526** |
| Cost allocated from support functions to business segments | (5,557) | (3,886) | (1,208) | (1,128) | 11,779 | - | **0** |
| **Profit (loss) before tax** | **15,594** | **19,856** | **934** | **4,409** | **(1,128)** | **(139)** | **39,526** |
| | | | | | | | |
| Net revenue from external customers | 19,264 | 37,624 | 3,781 | 2,824 | 231 | - | **63,724** |
| Net revenue (expenses) from other segments | 7,766 | (12,324) | 411 | 4,127 | 21 | - | **1** |
| **Total operating income** | **27,030** | **25,300** | **4,192** | **6,951** | **252** | **0** | **63,725** |
| | | | | | | | |
| **At 31 December 2014** | | | | | | | |
| **Total assets** | 348,010 | 453,134 | 19,350 | 455,077 | 31,000 | (208,201) | **1,098,370** |
| **Total liabilities** | 290,139 | 339,587 | 10,227 | 384,815 | 31,000 | (208,201) | **847,567** |
| **Allocated capital** | 57,871 | 113,547 | 9,123 | 70,262 | - | | **250,803** |

| 1 January - 31 December 2013 | Personal Banking | Corporate Banking | Markets | Treasury | Support functions | Recon-ciliation | Total |
|---|---|---|---|---|---|---|---|
| Net interest income (expense) | 17,615 | 14,364 | 443 | 3,552 | (36) | (1,624) | **34,314** |
| Net credit impairment charges and valuation adjustments | 68 | 12,899 | - | (195) | 281 | - | **13,053** |
| Net fee and commission income | 2,667 | 565 | 2,463 | 116 | (173) | (347) | **5,291** |
| Other net operating income | (1,331) | (1,062) | 5,640 | 8,014 | 76 | 1,586 | **12,923** |
| **Total operating income (expense)** | **19,019** | **26,766** | **8,546** | **11,487** | **148** | **(385)** | **65,581** |
| Operating expenses | (8,170) | (1,357) | (2,129) | (1,286) | (14,670) | 361 | **(27,251)** |
| Share of profit of equity-accounted associates | 300 | - | - | 2,412 | - | - | **2,712** |
| **Profit (loss) before cost allocation and tax** | **11,149** | **25,409** | **6,417** | **12,613** | **(14,522)** | **(24)** | **41,042** |
| Cost allocated from support functions to business segments | (6,225) | (2,656) | (1,178) | (801) | 10,860 | - | - |
| **Profit (loss) before tax** | **4,924** | **22,753** | **5,239** | **11,812** | **(3,662)** | **(24)** | **41,042** |
| | | | | | | | |
| Net revenue from external customers | 13,084 | 40,569 | 8,217 | 3,977 | 120 | - | **65,967** |
| Net revenue (expenses) from other segments | 5,935 | (13,801) | 329 | 7,510 | 27 | - | **0** |
| **Total operating income** | **19,019** | **26,768** | **8,546** | **11,487** | **147** | **0** | **65,967** |
| | | | | | | | |
| **At 31 December 2013** | | | | | | | |
| **Total assets** | 502,120 | 406,896 | 59,238 | 558,637 | 22,846 | (398,221) | **1,151,516** |
| **Total liabilities** | 449,219 | 323,591 | 50,457 | 462,265 | 22,846 | (398,221) | **910,157** |
| **Allocated capital** | 52,901 | 83,305 | 8,782 | 96,371 | - | | **241,359** |

## Notes to the Consolidated Income Statement

### 6. Net interest income

| Interest income | 2014 | 2013 |
|---|---|---|
| Cash and balances with Central Bank | 1,217 | 1,401 |
| Bonds and debt instruments classified as loans and receivables | 5,501 | 5,531 |
| Loans and advances to financial institutions | 442 | 668 |
| Loans and advances to customers | 46,551 | 52,529 |
| Other interest income | 24 | 3,097 |
| **Total** | **53,735** | **63,224** |
| **Interest expense** | | |
| Due to financial institutions and Central Bank | (2,768) | (2,958) |
| Deposits from customers | (15,179) | (16,608) |
| Secured bonds | (7,542) | (9,321) |
| Other interest expense | (173) | (23) |
| **Total** | **(25,662)** | **(28,910)** |
| **Net interest income** | **28,073** | **34,314** |
| Interest spread (as the annualised ratio of net interest income to the average carrying amount of total assets during the year). | **2.4%** | **3.1%** |
| Adjusted interest spread (as the annualised ratio of net interest income after net valuation adjustments and credit impairment charges to the average carrying amount of total assets during the year). | **4.2%** | **4.7%** |

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.

### 7. Net valuation adjustments and credit impairment charges

| | 2014 | 2013 |
|---|---|---|
| Net valuation adjustments to loans and advances acquired at deep discount | 20,010 | 19,440 |
| Net impairment loss | (2,038) | (7,706) |
| Reversals of loss from foreign currency linkage of loans and advances to customers | 2,156 | - |
| **Net valuation adjustments and impairment charges to loans and advances to customers** | **20,128** | **11,734** |
| Fair value change of contingent bond | - | 1,319 |
| **Net valuation adjustments and credit impairment charges** | **20,128** | **13,053** |
| **Valuation adjustments and impairment charges by customer type** | | |
| Individuals | 4,465 | (838) |
| Corporations | 15,663 | 12,573 |
| **Net valuation adjustments and impairment charges to loans and advances to customers** | **20,128** | **11,734** |

### 8. Net fee and commission income

| Fee and commission income | 2014 | 2013 |
|---|---|---|
| Markets and treasury | 1,377 | 1,408 |
| Asset management | 1,261 | 1,131 |
| Lending | 1,156 | 1,206 |
| Cards | 1,607 | 1,624 |
| Interbank clearing | 350 | 1,273 |
| Collection and payment services | 798 | 792 |
| Foreign trade | 813 | 659 |
| Other commissions and fees | 375 | 358 |
| **Total** | **7,737** | **8,451** |
| **Fee and commission expense** | | |
| Markets and treasury | (313) | (278) |
| Interbank clearing | (202) | (1,162) |
| Other fees | (1,386) | (1,720) |
| **Total** | **(1,901)** | **(3,160)** |
| **Net fee and commission income** | **5,836** | **5,291** |

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.

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

| | 2014 | 2013 |
|---|---|---|
| Bonds and debt instruments | (648) | 1,922 |
| Equities and equity instruments | 5,948 | 6,537 |
| **Total** | **5,300** | **8,460** |

### 10. Net gain on financial assets and liabilities held for trading

| | 2014 | 2013 |
|---|---|---|
| Bonds and debt instruments | 1,264 | 2,153 |
| Equities and equity instruments | 115 | 466 |
| Derivative instruments | 84 | (527) |
| **Total** | **1,463** | **2,092** |

### 11. Dividend income

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

| | 2014 | 2013 |
|---|---|---|
| Net gain on financial assets designated as at fair value through profit or loss | 1,302 | 418 |
| Net gain on financial assets and liabilities held for trading | 44 | 7 |
| **Total** | **1,346** | **425** |

### 12. Net foreign exchange gain (loss)

| **Assets** | 2014 | 2013 |
|---|---|---|
| Cash and balances with Central Bank | (17) | (137) |
| Bonds and debt instruments | 6,165 | (10,153) |
| Equities and equity instruments | (169) | (1,113) |
| Derivative instruments | (474) | 1,727 |
| Loans and advances to financial institutions | (86) | (3,737) |
| Loans and advances to customers | 3,293 | (18,493) |
| Other assets | 18 | (39) |
| **Total** | **8,730** | **(31,945)** |
| | | |
| **Liabilities** | | |
| Due to financial institutions and Central Bank | (391) | 1,710 |
| Deposits from customers | (2,997) | 6,932 |
| Secured bonds | (5,249) | 18,732 |
| Contingent bond | - | 5,516 |
| Other liabilities | (26) | 202 |
| **Total** | **(8,663)** | **33,092** |
| | | |
| **Net foreign exchange gain** | **67** | **1,147** |

The foreign exchange differences, which were recognised during the year 2014 in the Consolidated Income Statement and arose on financial instruments not measured at fair value through profit or loss, amounted to a gain of ISK 3,208 million for financial assets (2013: loss of ISK 22,406 million) and a loss of ISK 8,663 million for financial liabilities (2013: gain ISK 33,092 million).

### 13. Other income and expenses

| | 2014 | 2013 |
|---|---|---|
| Recharged expenses | 183 | 160 |
| (Loss), gain on sale of property and equipment | (40) | 277 |
| Loss on repossessed collateral | (8) | (363) |
| Gain on sale of equity-accounted associates | 3,918 | 836 |
| Other | (1,771) | 314 |
| **Total** | **2,282** | **1,224** |

## Notes to the Consolidated Financial Statements

### 14. Salaries and related expenses

| | 2014 | 2013 |
|---|---|---|
| Salaries | 10,428 | 9,477 |
| Contributions to defined pension plans | 1,489 | 1,399 |
| Social security contributions, special financial activities tax on salaries and other expenses | 1,650 | 1,737 |
| **Total** | **13,567** | **12,613** |
| | | |
| 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** | **4,691** |
| | | |
| **Total salaries and related expenses** | **13,567** | **17,304** |
| | | |
| Number of full-time equivalent positions at year-end | 1,126 | 1,183 |
| Average number of full-time equivalent positions during the year | 1,155 | 1,193 |

### 15. Other operating expenses

| | 2014 | 2013 |
|---|---|---|
| Computer software and other information technology costs | 1,961 | 1,675 |
| Real estate and fixtures | 770 | 995 |
| Advertising and marketing | 814 | 760 |
| Operating lease rentals | 648 | 658 |
| FME supervisory expenses | 337 | 383 |
| Contribution to the Debtor's Ombudsman | 141 | 230 |
| Audit and related services | 138 | 128 |
| Other professional services | 1,002 | 788 |
| Other operating expenses | 2,734 | 2,433 |
| **Total** | **8,545** | **8,050** |

| **Audit and related services** | **2014** | **2013** |
|---|---|---|
| Audit of financial statement and audit related service | 75 | 61 |
| Review of interim financial statements and audit related services | 63 | 67 |
| **Total** | **138** | **128** |

### 16. Income tax and other taxes

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% (2013: 20.0%). An additional special income tax on financial institutions is recognised at a rate of 6% on an 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:

| | 2014 | 2013 |
|---|---|---|
| Current tax expense | (6,183) | (6,364) |
| Special income tax on financial institutions | (1,771) | (2,018) |
| Difference of prior year's imposed and calculated income tax | 237 | 20 |
| Deferred tax expense | 896 | (638) |
| **Total** | **(6,821)** | **(9,000)** |

## 16. Income tax and other taxes (continued)

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

| | | 2014 | | 2013 |
|---|---|---|---|---|
| Profit before tax | | 39,526 | | 41,042 |
| Tax on liabilities of financial institutions | | (2,968) | | (3,283) |
| Profit before income tax | | 36,558 | | 37,759 |
| Income tax calculated using the domestic corporate income tax rate | 20.0% | (7,312) | 20.0% | (7,552) |
| Special income tax on financial institutions | 4.8% | (1,771) | 5.3% | (2,018) |
| Income not subject to tax | (6.1%) | 2,237 | (5.5%) | 2,060 |
| Non-deductable expenses | 2.5% | (917) | 4.0% | (1,492) |
| Other | (2.6%) | 941 | 0.0% | 2 |
| **Effective income tax** | **18.7%** | **(6,821)** | **23.8%** | **(9,000)** |

*Tax on liabilities of financial institutions*

On 31 December 2013 the Parliament of Iceland passed an amendment to Act No. 155/2010, on Special Tax on Financial Institutions, according to which financial institutions must pay annually a tax calculated as 0.376% (2013: 0.376%) of the carrying amount of total liabilities at year-end in excess of ISK 50,000 million as determined for tax purposes.

| | 2014 | 2013 |
|---|---|---|
| Tax on liabilities of financial institutions | 2,968 | (3,283) |
| **Total** | **2,968** | **(3,283)** |

## Notes to the Consolidated Statement of Financial Position

### 17. 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 2014:

| 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 | 10,160 | - | - | - | - | 10,160 | 10,160 |
| Bonds and debt instruments | 113,074 | 106,788 | 23,727 | - | - | 243,589 | 243,663 |
| Equities and equity instruments | - | 5,871 | 23,562 | - | - | 29,433 | 29,433 |
| Derivative instruments | - | 78 | - | - | - | 78 | 78 |
| Loans and advances to financial institutions | 49,789 | - | - | - | - | 49,789 | 49,789 |
| Loans and advances to customers | 718,355 | - | - | - | - | 718,355 | 726,505 |
| Other financial assets | 19,733 | - | - | - | - | 19,733 | 19,733 |
| **Total** | **911,111** | **112,737** | **47,289** | **0** | **0** | **1,071,137** | **1,079,361** |
| **Financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | - | - | - | 53,827 | - | 53,827 | 53,826 |
| Deposits from customers | - | - | - | 551,435 | - | 551,435 | 551,468 |
| Derivative instruments and short positions | - | 5,409 | - | - | - | 5,409 | 5,409 |
| Secured bonds | - | - | - | 207,028 | - | 207,028 | 207,557 |
| Other financial liabilities | - | - | - | 7,509 | - | 7,509 | 7,509 |
| **Total** | **0** | **5,409** | **0** | **819,799** | **0** | **825,208** | **825,769** |

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 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 | 21,520 | - | - | - | - | 21,520 | 21,520 |
| Bonds and debt instruments | 111,902 | 151,894 | 26,799 | - | - | 290,595 | 292,329 |
| Equities and equity instruments | - | 3,965 | 32,310 | - | - | 36,275 | 36,275 |
| Derivative instruments | - | 654 | - | - | - | 654 | 654 |
| Loans and advances to financial institutions | 67,916 | - | - | - | - | 67,916 | 67,916 |
| Loans and advances to customers | 680,468 | - | - | - | - | 680,468 | 685,159 |
| Other financial assets | 6,366 | - | - | - | - | 6,366 | 6,366 |
| **Total** | **888,172** | **156,513** | **59,109** | **0** | **0** | **1,103,794** | **1,110,219** |
| **Financial liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | - | - | - | 167,218 | - | 167,218 | 167,218 |
| Deposits from customers | - | - | - | 456,662 | - | 456,662 | 456,637 |
| Derivative instruments and short positions | - | 7,571 | - | - | - | 7,571 | 7,571 |
| Secured bonds | - | - | - | 239,642 | - | 239,642 | 239,642 |
| Other financial liabilities | - | - | - | 12,320 | - | 12,320 | 12,320 |
| **Total** | **0** | **7,571** | **0** | **875,842** | **0** | **883,413** | **883,388** |

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

The fair value of financial assets and liabilities is 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 the 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 estimated are based on statement of financial position information or expert opinion.

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 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. Expected future cash flows are discounted at current market rates to determine fair value.

### Due to financial institutions and Central Bank

Amounts due to financial institutions and the 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 the market rates of the deposits at the reporting date.

### Short positions

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

### Secured bonds

Secured bonds are initially measured at fair value plus directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method.

### Covered bonds

The covered bonds are initially measured at fair value plus directly attributable transaction costs, and are subsequently measured at amortised cost using the effective interest method.

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

### 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 inputs. The most recent transaction prices in combination with generally accepted valuation methods are used to measure fair value of shares. However, the yield of actively traded bonds with the same duration is used as a benchmark for the valuation of bonds.

• Level 3: Valuation technique based on significant non-observable inputs. It covers all instruments for which the valuation technique includes inputs based on unobservable data and the unobservable inputs have significant effect on the instrument's valuation. For unlisted shares and bonds where there is 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 companie's multiples are the most commonly used methods to calculate fair value of unlisted shares in addition to recent transactions and current market conditions.

Assumptions and inputs used in the valuation technique include risk-free and benchmark interest rates for estimating discount rates, credit spreads, bonds and equity prices, foreign currency exchange rates, market multipliers, market conditions for estimating future growth and other market indicators.

### Valuation framework

The Bank's Risk and Finance Committee oversees the Group's overall risk and is responsible for fair value measurements of financial assets and liabilities classified as Level 2 and 3 instruments. The Bank's Valuation group reports its valuation results to the Risk & Finance Committee for verification. The Valuation group is comprised of personnel from Risk Management, Treasury and Accounting. The Valuation group holds meetings monthly to determine the value of Level 2 and Level 3 financial assets and liabilities.

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 2014:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 107,418 | 15,066 | 8,031 | 130,515 |
| Equities and equity instruments | 7,525 | - | 21,908 | 29,433 |
| Derivative instruments | - | 78 | - | 78 |
| **Total** | **114,943** | **15,144** | **29,939** | **160,026** |
| **Financial liabilities** | | | | |
| Derivative instruments | - | 332 | - | 332 |
| Short positions | 5,077 | - | - | 5,077 |
| **Total** | **5,077** | **332** | **0** | **5,409** |

During the year 2014 there were no transfers between Level 1, Level 2 and Level 3.

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 2013:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 152,472 | 15,547 | 10,674 | 178,693 |
| Equities and equity instruments | 8,209 | 1 | 28,064 | 36,275 |
| Derivative instruments | - | 654 | - | 654 |
| **Total** | **160,681** | **16,202** | **38,738** | **215,622** |
| **Financial liabilities** | | | | |
| Derivative instruments | - | 583 | - | 582 |
| Short positions | 6,988 | - | - | 6,988 |
| **Total** | **6,988** | **583** | **0** | **7,571** |

During the year 2013, certain securities with a carrying amount of ISK 30.000 million were transferred from Level 2 to Level 1 in the fair value hierarchy due to changes in market conditions. Price determination of these securities became more dynamic; consequently, unadjusted quoted prices can be used as a measurement of fair value.

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

The following table shows the Level in the hierarchy into which the fair value of financial assets and liabilities, not carried at fair value in the Consolidated Statement of Financial Position, are categorised as at 31 December 2014:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | - | 10,160 | - | 10,160 |
| Bonds and debt instruments | 100,356 | 12,792 | - | 113,148 |
| Loans and advances to financial institutions | - | 49,789 | - | 49,789 |
| Loans and advances to customers | - | - | 726,505 | 726,505 |
| Other financial assets | - | 19,733 | - | 19,733 |
| **Total** | **100,356** | **92,474** | **726,505** | **919,335** |
| **Financial liabilities** | | | | |
| Due to financial institutions and Central Bank | - | 53,826 | - | 53,826 |
| Deposits from customers | - | 551,468 | - | 551,468 |
| Secured bonds | - | 207,557 | - | 207,557 |
| Other financial liabilitites | - | 7,509 | - | 7,509 |
| **Total** | **0** | **820,360** | **0** | **820,360** |

The following table shows the Level in the hierarchy into which the fair value of financial assets and liabilities, not carried at fair value in the Consolidated Statement of Financial Position, are categorised as at 31 December 2013:

| Financial assets | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Cash and balances with Central Bank | - | 21,520 | - | 21,520 |
| Bonds and debt instruments | 102,033 | 11,603 | - | 113,636 |
| Loans and advances to financial institutions | - | 67,916 | - | 67,916 |
| Loans and advances to customers* | - | - | 685,159 | 685,159 |
| Other financial assets | - | 6,366 | - | 6,366 |
| **Total** | **102,033** | **107,405** | **685,159** | **894,597** |
| **Financial liabilities** | | | | |
| Due to financial institutions and Central Bank | - | 167,218 | - | 167,218 |
| Deposits from customers | - | 456,637 | - | 456,637 |
| Secured bonds | - | 239,642 | - | 239,642 |
| Other financial liabilitites | - | 12,320 | - | 12,320 |
| **Total** | **0** | **875,817** | **0** | **875,817** |

*Loans and advances to customers are reclassified from Level 2 to Level 3. The reclassification has no effect on the comparative amounts in the income statement or statement of financial position for the year 2013.

The following tables show the reconciliation of fair value measurement in Level 3 for the year 2014 and 2013:

| 1 January - 31 December 2014 | Bonds and debt instruments | Equities and equity instruments | Total financial assets | Contingent Bond |
|---|---|---|---|---|
| Carrying amount as at 1 January 2014 | 10,674 | 28,064 | 38,738 | - |
| Total gains (losses) recognised in income statement | (1,692) | 5,894 | 4,202 | - |
| Purchases | - | 360 | 360 | - |
| Sales | (209) | (15,889) | (16,098) | - |
| Settlements | (742) | - | (742) | - |
| Dividend received | - | (1,054) | (1,054) | - |
| Reclassification from investments in equity-accounted associates | - | 4,533 | 4,533 | - |
| **Carrying amount as at 31 December 2014** | **8,031** | **21,908** | **29,939** | **0** |
| **1 January - 31 December 2013** | | | | |
| Carrying amount as at 1 January 2013 | 10,611 | 29,877 | 40,488 | (87,474) |
| Total gains recognised in income statement | 474 | 5,561 | 6,035 | 6,212 |
| Change in Contingent Bond | - | - | - | (4,691) |
| Purchases | - | 56 | 56 | - |
| Sales | (436) | (8,432) | (8,868) | - |
| Settlements | 25 | - | 25 | 85,953 |
| Winding-up proceedings of subsidiary | - | 1,002 | 1,002 | - |
| **Carrying amount as at 31 December 2013** | **10,674** | **28,064** | **38,738** | **0** |

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

The following tables show the line items in the Consolidated Income Statement where the total gains (losses) were recognised during the year 2014 and 2013, for fair value measurements in Level 3:

| 1 January - 31 December 2014 | Bonds and debt instruments | Equities and equity instruments | Contingent Bond | Total |
|---|---|---|---|---|
| Net gain on financial assets designated as at fair value through profit or loss | (1,437) | 6,101 | - | 4,664 |
| Net foreign exchange gain (loss) | (255) | (207) | - | (462) |
| **Total** | **(1,692)** | **5,894** | **0** | **4,202** |
| **1 January - 31 December 2013** | | | | |
| 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 | 1,045 | 6,300 | - | 7,345 |
| Net foreign exchange gain (loss) | (571) | (739) | 5,516 | 4,206 |
| **Total** | **474** | **5,561** | **6,212** | **12,247** |

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 2014 and categorised in Level 3, were recognised:

| | Bonds and debt instruments | Equities and equity instruments | Contingent Bond | Total |
|---|---|---|---|---|
| Net gain on financial assets designated as at fair value through profit or loss | (1,455) | 6,580 | - | 5,125 |
| Net foreign exchange gain (loss) | (235) | (2) | - | (237) |
| **Total** | **(1,690)** | **6,578** | **0** | **4,888** |

### Unobservable inputs in fair value measurement

The following table shows the unobservable inputs used in measuring fair value for the year 2014.

| | | | | | Range of inputs | |
|---|---|---|---|---|---|---|
| At 31 December 2014 | Assets | Liabilities | Valuation technique | Key unobservable inputs | Lower | Higher |
| Bonds and debt instruments | 8,031 | - | See note 1) | See note 1) | n/a | n/a |
| Equities and equity instruments | 21,908 | - | See note 2) | See note 2) | n/a | n/a |
| | **29,939** | **0** | | | | |

The table above provides information on Level 3 financial assets and liabilities. A further description of the categories is given below:

1. Fair value of corporate bonds and claims on financial institutions in winding-up proceedings and other insolvent assets is estimated on the basis of an analysis of the estates' financial position and expected recovery. Reference is also made to prices in recent transactions. Given the nature of the valuation method, a range of key unobservable inputs is not available.

2. Equities and equity instruments classified as Level 3 assets, are unlisted and not traded in an active market and therefore subject to unobservable inputs for fair value measurements. Valuation using discounted cash flows, comparison of peer companies' multiples, analysis of financial position and results, outlook and recent transactions are the methods or inputs used to estimate fair value of investments in equities and equity instruments. Given the nature of the valuation method, a range of key unobservable inputs is not available.

### The effect of unobservable inputs in fair value measurement

Although the Group believes that its estimates of fair value are appropriate, the use of different valuation methodologies and assumptions could lead to different estimates 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 likely alternatives:

| | Effect on profit before tax | |
|---|---|---|
| | Favourable | Unfavourable |
| Bonds and debt instruments | 402 | (402) |
| Equities and equity instruments: | | |
| Equities | 992 | (855) |
| Mutual funds | 315 | (315) |
| Total equities and equity instruments | 1,307 | (1,170) |
| **Total** | **1,709** | **(1,572)** |

The effect on profit was calculated using methods suitable for the models used. Key unobservable inputs were changed by +/- 5%.

## 18. Cash and balances with Central Bank

| | 2014 | 2013 |
|---|---|---|
| Cash on hand | 3,463 | 3,465 |
| Term deposits with Central Bank | - | 10,013 |
| Unrestricted balances with Central Bank | - | 1,586 |
| **Total cash and unrestricted balances with Central Bank** | **3,463** | **15,064** |
| | | |
| Restricted balances with Central Bank | 6,697 | 6,456 |
| **Total cash and balances with Central Bank** | **10,160** | **21,520** |

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 itself 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 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 10,323 million for December 2014 (December 2013: ISK 7,857 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.

## 19. Bonds and equities

| | 2014 | | | | 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| **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 | 113,074 | 39,129 | 15,706 | 167,909 | 111,902 | 38,152 | 612 | 150,666 |
| Unlisted | - | 700 | 8,021 | 8,721 | - | 1,619 | 26,187 | 27,806 |
| | **113,074** | **39,829** | **23,727** | **176,630** | **111,902** | **39,771** | **26,799** | **178,472** |
| **Foreign** | | | | | | | | |
| Listed | - | 66,959 | - | 66,959 | - | 112,123 | - | 112,123 |
| Unlisted | - | - | - | 0 | - | - | - | 0 |
| | **0** | **66,959** | **0** | **66,959** | **0** | **112,123** | **0** | **112,123** |
| | | | | | | | | |
| **Total bonds** | **113,074** | **106,788** | **23,727** | **243,589** | **111,902** | **151,894** | **26,799** | **290,595** |
| **Equities and equity instruments** | | | | | | | | |
| **Domestic** | | | | | | | | |
| Listed | - | 5,869 | 88 | 5,957 | - | 3,047 | 775 | 3,822 |
| Unlisted | - | - | 23,255 | 23,255 | - | 917 | 28,846 | 29,763 |
| | **0** | **5,869** | **23,343** | **29,212** | **0** | **3,964** | **29,621** | **33,585** |
| **Foreign** | | | | | | | | |
| Listed | - | 2 | 73 | 75 | - | 1 | 2,617 | 2,618 |
| Unlisted | - | - | 146 | 146 | - | - | 72 | 72 |
| | **0** | **2** | **219** | **221** | **0** | **1** | **2,689** | **2,690** |
| | | | | | | | | |
| **Total equities** | **0** | **5,871** | **23,562** | **29,433** | **0** | **3,965** | **32,310** | **36,275** |
| | | | | | | | | |
| **Total bonds and equities** | **113,074** | **112,659** | **47,289** | **273,022** | **111,902** | **155,859** | **59,109** | **326,870** |

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

Bonds and debt instruments classified as loans and receivables as at 31 December 2014 and 2013 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.

## 20. Derivative instruments and short positions

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Notional | Fair value | | Notional | Fair value | |
| **Foreign exchange derivatives** | amount | Assets | Liabilities | amount | Assets | Liabilities |
| Currency forwards | 24,024 | 39 | 52 | 43,608 | 637 | 68 |
| Cross-currency interest rate swaps | 871 | - | 251 | 1,098 | - | 453 |
| | **24,895** | **39** | **303** | **44,706** | **637** | **521** |
| **Interest rate derivatives** | | | | | | |
| Interest rate swaps | 500 | - | 8 | - | - | - |
| Total return swaps | 1,453 | 3 | - | 5,178 | 3 | 9 |
| Bond options | 750 | - | 12 | - | - | - |
| | **2,703** | **3** | **20** | **5,178** | **3** | **9** |
| **Equity derivatives** | | | | | | |
| Total return swaps | 1,726 | 36 | 9 | 2,067 | 14 | 52 |
| Equity forwards | - | - | - | - | - | - |
| | **1,726** | **36** | **9** | **2,067** | **14** | **52** |
| **Short positions - listed bonds** | - | - | 5,077 | - | - | 6,988 |
| **Total** | **29,324** | **78** | **5,409** | **51,951** | **654** | **7,571** |

The Group uses derivatives both for hedging and trading purposes.

## 21. Loans and advances to financial institutions

| | 2014 | 2013 |
|---|---|---|
| Bank accounts with financial institutions | 13,125 | 4,863 |
| Money market loans | 22,209 | 49,625 |
| Overdrafts | 6,892 | 6,394 |
| Other loans | 7,563 | 7,034 |
| **Total** | **49,789** | **67,916** |

## 22. Loans and advances to customers

| | 2014 | 2013 |
|---|---|---|
| Public entities | 13,831 | 10,149 |
| Individuals | 254,955 | 217,719 |
| Corporations | 491,016 | 503,544 |
| Allowance for impairment | (41,447) | (50,944) |
| **Total** | **718,355** | **680,468** |

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 disclosure on loans and advances is provided in the risk management notes to these Consolidated Financial Statements.

## 23. Investments in associates

| a) Investments in equity-accounted associates | 2014 | 2013 |
|---|---|---|
| Carrying amount as at the beginning of the year | 14,224 | 15,528 |
| Acquisition | 1,308 | 2,468 |
| Reclassification to equities and equity instruments | (4,533) | (4) |
| Share of profit of equity-accounted associates | 465 | 2,712 |
| Disposals and dividend received | (10,687) | (6,480) |
| **Total** | **777** | **14,224** |

| At 31 December 2014* | Total assets | Total liabilities | Profit (loss) | Ownership interest | Share of profit of associates | Carrying amount |
|---|---|---|---|---|---|---|
| Reiknistofa bankanna hf. | 3,168 | 1,668 | 211 | 37% | 77 | 552 |
| Auðkenni ehf. | 311 | 44 | (262) | 21% | (56) | 56 |
| Greiðslumiðlun Íslands ehf. | 350 | 2 | 338 | 48% | 162 | 167 |
| Valitor Holding hf. | - | - | - | - | 117 | - |
| Borgun hf. | - | - | - | - | 198 | - |
| Motus ehf. | - | - | - | - | (33) | - |
| Other | - | - | - | - | - | 2 |
| **Total** | **3,829** | **1,714** | **287** | | **465** | **777** |
| **At 31 December 2013*** | | | | | | |
| Valitor Holding hf. | 42,527 | 35,058 | (352) | 38% | (137) | 2,905 |
| Framtakssjóður Íslands slhf. | 35,862 | 3,669 | 7,636 | 28% | 2,134 | 8,882 |
| Borgun hf. | 24,914 | 21,899 | 960 | 31% | 301 | 960 |
| Reiknistofa bankanna hf. | 2,186 | 522 | 91 | 37% | 3 | 613 |
| Motus ehf. | 714 | 390 | 225 | 48% | 137 | 191 |
| Auðkenni ehf. | 287 | 38 | (163) | 20% | (39) | 50 |
| IEI slhf. | 2,251 | - | - | 28% | - | 621 |
| Reginn hf. | - | - | - | - | 315 | - |
| Other | - | - | - | - | (1) | 2 |
| **Total** | **108,742** | **61,576** | **8,397** | | **2,712** | **14,224** |

*The amounts for the years 2013 and 2014 in the tables are estimates, not actual amounts at the end of the respective years, if actual amounts were not readily available.

During the year 2014, the Group sold all of its shares in Valitor Holding hf, Borgun hf., IEI slhf. and 9,9% shareholding in Framtakssjóður Íslands slhf. The remaining shares in Framtakssjóður Íslands slhf. have been reclassified to equities and equity instruments. All associates are unlisted companies.

During the year Greiðslumiðlun Íslands ehf. acquired all the shares in Motus ehf. Payment for the shares was in the form of shares in Greiðslumiðlun Íslands ehf. The Bank therefore has the same percentage share in Greiðslumiðlun Íslands ehf. as the Bank previously held in Motus ehf., which is now a subsidiary of Greiðslumiðlun Íslands ehf.

The sale of the Bank´s 38% shareholding in Valitor Holding hf. to Arion Bank included, inter alia, an agreement on additional considerations for the Bank's shares in Valitor. The agreement stipulates that Arion Bank will pay additional considerations to the Bank if Valitor, or a subsidiary of Valitor, receives proceeds from Visa Europe in relation to a specific option agreement that exists between Visa Europe and Visa Inc. The Bank has not recognised any amount in these financial statements in relation to the potential additional considerations, as the decision to exercise the option is neither at the control of the Bank nor Arion Bank, there is significant uncertainty as to whether or when any proceeds relating to the option would be received and there is significant uncertainty regarding the possible value of such proceeds.

### b) Investments in associates designated as at fair value through profit or loss

One investment in associate is accounted for in its 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”. This investment is a 23.3% in Eyrir Invest hf.

## 24. Property and equipment

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Buildings | Fixtures, equipment and vehicles | Total | Buildings | Fixtures, equipment and vehicles | Total |
| Carrying amount as at the beginning of the year | 2,810 | 2,631 | 5,441 | 4,466 | 2,310 | 6,776 |
| Additions during the year | 960 | 294 | 1,254 | - | 820 | 820 |
| Sold during the year | (208) | (6) | (214) | (1,581) | (7) | (1,588) |
| Depreciation | (68) | (722) | (790) | (75) | (493) | (568) |
| **Carrying amount as at 31 December** | **3,494** | **2,197** | **5,691** | **2,810** | **2,631** | **5,440** |
| | | | | | | |
| Gross carrying amount | 3,851 | 4,592 | 8,443 | 3,135 | 5,950 | 9,085 |
| Accumulated depreciation | (357) | (2,395) | (2,752) | (326) | (3,319) | (3,645) |
| **Carrying amount as at 31 December** | **3,494** | **2,197** | **5,691** | **2,810** | **2,631** | **5,440** |
| | | | | | | |
| Depreciation rates | 2-4% | 10-33% | | 2-4% | 10-33% | |

| **Official assessment value of buildings as at 31 December** | **2014** | **2013** |
|---|---|---|
| Official assessment value | 3,718 | 3,948 |
| Replacement value | 8,129 | 8,817 |

| **Depreciation and amortisation presented in the income statement consists of** | **2014** | **2013** |
|---|---|---|
| Depreciation of property and equipment | 790 | 568 |
| Amortisation of intangible assets | 152 | 249 |
| **Total** | **942** | **818** |

## 25. Intangible assets

| **Computer software licenses** | **2014** | **2013** |
|---|---|---|
| Carrying amount as at the beginning of the year | 585 | 541 |
| Additions | 792 | 293 |
| Amortisation | (152) | (249) |
| **Carrying amount** | **1,225** | **585** |
| | | |
| Gross carrying amount | 2,655 | 1,863 |
| Accumulated amortisation | (1,430) | (1,278) |
| **Carrying amount** | **1,225** | **585** |
| | | |
| Amortisation rates | 20-33% | 20-33% |

## 26. Other assets

| | **2014** | **2013** |
|---|---|---|
| Unsettled securities trading | 16,468 | 863 |
| Other accounts receivable | 3,265 | 3,248 |
| Claim on LBI hf. due to court ruling | - | 2,255 |
| Sundry assets | 1,245 | 2,449 |
| **Total** | **20,978** | **8,816** |

## 27. Assets classified as held for sale

| | **2014** | **2013** |
|---|---|---|
| Repossessed collateral | 12,270 | 17,213 |
| Assets of disposal groups | 5,942 | 7,810 |
| **Total** | **18,212** | **25,023** |

### 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. Repossessed collateral is recognised as assets of either the Bank or its subsidiary Hömlur ehf.

## 27. Assets classified as held for sale (continued)

| Repossessed collateral | 2014 | 2013 |
|---|---|---|
| Carrying amount as at the beginning of the year | 17,213 | 25,221 |
| Repossessed during the year | 8,151 | 11,543 |
| Disposed of during the year | (11,678) | (16,366) |
| Impairment and loss of sale | (1,416) | (3,185) |
| **Carrying amount as at the end of the year** | **12,270** | **17,213** |

### 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.

## 28. Due to financial institutions and Central Bank

| | 2014 | 2013 |
|---|---|---|
| Loans and repurchase agreements with Central Bank | 197 | 115 |
| Loans and deposits from financial institutions | 53,630 | 167,103 |
| **Total** | **53,827** | **167,218** |

## 29. Deposits from customers

| | 2014 | 2013 |
|---|---|---|
| Demand deposits | 380,518 | 345,086 |
| Time deposits | 170,917 | 111,575 |
| **Total** | **551,435** | **456,662** |

## 30. Secured bonds

| As at 31.12.2014 | Currency | Final maturity | Remaining principal | Contractual interest rate (Base rate + Initial margin/ Step-up margin) | Carrying amount |
|---|---|---|---|---|---|
| EUR Bonds | EUR | 9.10.2016 | € 99 million | EURIBOR + 2.90% | 15,276 |
| USD Bonds | USD | 9.10.2016 | $ 18 million | LIBOR + 2.90% | 2,285 |
| GBP Bonds | GBP | 9.10.2016 | £ 66 million | LIBOR + 2.90% | 13,083 |
| EUR Bonds | EUR | 9.10.2018 | € 132 million | EURIBOR + 2.90% | 20,368 |
| USD Bonds | USD | 9.10.2018 | $ 24 million | LIBOR + 2.90% | 3,047 |
| GBP Bonds | GBP | 9.10.2018 | £ 88 million | LIBOR + 2.90% | 17,443 |
| USD Bonds | USD | 9.10.2020 | $ 271 million | LIBOR + 2.90% / 3.50% | 34,402 |
| EUR Bonds | EUR | 9.10.2022 | € 192 million | EURIBOR + 2.90% / 3.65% | 29,626 |
| USD Bonds | USD | 9.10.2024 | $ 271 million | LIBOR + 2.90% / 3.95% | 34,402 |
| EUR Bonds | EUR | 9.10.2026 | € 192 million | EURIBOR + 2.90% / 4.05% | 29,626 |
| **Total issued bonds to LBI hf.** | | | | | **199,558** |

| As at 31.12.2014 | Currency | Final maturity | Remaining principal | Fixed contractual interest rate | Carrying amount |
|---|---|---|---|---|---|
| LBANK CB 16 | ISK | 10.6.2016 | 3,360 | 6.3% | 3,476 |
| LBANK CB 17 | ISK | 23.10.2017 | 1,340 | 6.0% | 1,345 |
| LBANK CB 19 | ISK | 17.9.2019 | 2,580 | 6.8% | 2,649 |
| **Total covered bonds** | | | | | **7,470** |
| | | | | | |
| **Total secured bonds as at 31.12.2014** | | | | | **207,028** |

### 30. Secured bonds (continued)

| As at 31.12.2013 | Currency | Final maturity | Remaining principal | Contractual interest rate (Base rate + Margin) | Carrying amount |
|---|---|---|---|---|---|
| EUR Bonds | EUR | 9.10.2018 | € 755 million | EURIBOR + 2.90% | 119,808 |
| GBP Bonds | GBP | 9.10.2018 | £ 241 million | LIBOR + 2.90% | 45,877 |
| USD Bonds | USD | 9.10.2018 | $ 625 million | LIBOR + 2.90% | 72,032 |
| **Total issued bonds to LBI hf.** | | | | | **237,717** |

| As at 31.12.2013 | Currency | Final maturity | Remaining principal | Fixed contractual interest rate | Carrying amount |
|---|---|---|---|---|---|
| LBANK CB 16 | ISK | 10.6.2016 | 1,860 | 6.3% | 1,925 |
| **Total covered bonds** | | | | | **1,925** |
| | | | | | |
| **Total secured bonds as at 31.12.2013** | | | | | **239,642** |

The secured foreign currency bonds which the Bank issued to LBI hf. as a consideration and an additional consideration for the assets and liabilities transferred from LBI hf. to the Bank on 9 October 2008 consisted originally of bonds issued in October 2010 and April 2013, alias the Original Bonds.

The repayment schedule of the Original Bonds assumed repayments during the years 2014-2018. On 8 May 2014, the Bank and the Winding-up Board of LBI hf. reached an agreement to extend the repayment schedule to the years 2014-2026. The agreement was conditional upon the Winding-up Board of LBI hf. obtaining certain exemptions from capital controls from the Central Bank of Iceland, which approved the exemptions on 4 December 2014. As of that date, the agreement became effective under the Amendment and Restatement Agreement, as amended from 12 June 2014, and amended and restated Pledge Agreement from 4 December 2014 between the Bank and the Winding-up Board of LBI hf.

As at the effective date of the agreement, 4 December 2014, the Bank was required to make prepayments in respect of the outstanding principal amount of the Original Bonds. After the prepayments, the Original Bonds were simultaneously replaced with ten bonds in accordance with the Amendment and Restatement Agreement, as amended, from 12 June 2014.

Under the agreement the repayments of the ten bonds are scheduled for the years 2016-2026 with bond tranches maturing every second year throughout the period, as summarised in the table above. Furthermore, in the event that the Bank's long-term credit rating in foreign currency, as then rated by Standard & Poor's, is below BBB- as of 30 June 2018, the Bank will have the option to amend and extend partly or wholly the maturity date of the tranches maturing in 2018 and 2020.

Interest rate terms will remain unchanged at 3-month EURIBOR for the EUR-denominated bonds and 3-month LIBOR for the GBP and USD-denominated bonds plus a 2.90% margin until October 2018, stepping up to a 3.50% margin for the 2020 tranche, a 3.65% margin for the 2022 tranche, a 3.95% margin for the 2024 tranche and a 4.05% margin for the 2026 tranche.

Under this agreement the Bank is further required to use proceeds from any new foreign currency debt financing, above a certain threshold, to make prepayments on the bonds. Otherwise, the Bank will have increased flexibility in terms of how optional and mandatory prepayments of the bonds will be applied against outstanding maturities, without any additional costs.

Furthermore, the Bank will not be required to convert any outstanding bonds to Eurobonds before October 2018 and certain restrictions on dividend payments are removed.

During the year 2014, the Bank concluded the sale of an additional tranche of its covered bond series, LBANK CB 16. These bonds are non-indexed with a 3-year fixed interest rate of 6.3%. This tranche was in the amount of ISK 1,500 million. The total size of this bond series is limited to ISK 10,000 million.

During the year 2014, the Bank concluded sales of tranches of the new series of its covered bonds, LBANK CB 17. These bonds are non-indexed with a 3-year fixed interest rate of 6.0%. These tranches were in the amount of ISK 1,400 million. The total size of this bond series is limited to ISK 10,000 million.

During the year 2014, the Bank concluded sales of tranches of the new series of its covered bonds, LBANK CB 19. These bonds are non-indexed with a 5-year fixed interest rate of 6.8%. These tranches were in the amount of ISK 2,640 million. The total size of this covered bond series is limited to ISK 10,000 million.

The covered bond issues provide broader funding opportunities for the Bank's mortgage portfolio and reduce the Bank's fixed interest rate risk. The three series, LBANK CB 16, LBANK CB 17 and LBANK CB 19, have been admitted for trading on NASDAQ OMX Iceland.

The Bank has committed itself to pledge certain pools of loans to customers as collateral for the secured foreign currency bonds issued to LBI hf. and the issues of covered bonds. The minimum coverage ratio requirement for the secured bonds issued to LBI hf. has been reduced from 124.7% to 115% under the agreement between the Bank and the Winding-up Board of LBI hf. from 12 June 2014 and the pledge agreement for these bonds from 4 December 2014. The minimum coverage ratio requirement for the covered bonds is 120%. For further details on encumbered assets, see Note 77.

## 31. Deferred tax assets and liabilities

Tax assets and liabilities are specified as follows:

| Tax assets | 2014 | 2013 |
|---|---|---|
| Deferred tax assets | 83 | - |
| **Tax liabilities** | | |
| Deferred tax liabilities | - | (590) |

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

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Assets | Liabilities | Net | Assets | Liabilities | Net |
| Property and equipment | - | (284) | (284) | - | (524) | (524) |
| Intangibles | - | (38) | (38) | - | (54) | (54) |
| Loans and advances to customers | 186 | - | 186 | 416 | - | 416 |
| Deferred foreign exchange differences | - | (148) | (148) | - | (434) | (434) |
| Other items | - | (128) | (128) | - | (269) | (269) |
| Tax losses carried forward | 495 | - | 495 | 275 | - | 275 |
| | **681** | **(598)** | **83** | **691** | **(1,281)** | **(590)** |
| Set-off of deferred tax assets together with liabilities of the same taxable entities | (598) | 598 | - | (691) | 691 | - |
| **Total** | **83** | **0** | **83** | **0** | **(590)** | **(590)** |

The deferred tax assets and liabilities are measured based on the tax rates and tax laws enacted by the end of 2014, according to which the domestic corporate income tax rate was 20% as at 31 December 2014 (2013: 20%).

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

| | | Recognised in income statement | | |
|---|---|---|---|---|
| **2014** | Balance 1.1 | Tax (expense) income | Changes from prior year | Balance 31.12 |
| Property and equipment | (524) | 240 | - | (284) |
| Intangibles | (54) | 16 | - | (38) |
| Loans and advances to customers | 416 | (230) | - | 186 |
| Deferred foreign exchange differences | (434) | 286 | - | (148) |
| Other items | (269) | 141 | - | (128) |
| Tax losses carried forward | 275 | 443 | (223) | 495 |
| **Total** | **(590)** | **896** | **(223)** | **83** |
| **2013** | | | | |
| Property and equipment | (1,061) | 537 | - | (524) |
| Intangibles | (105) | 51 | - | (54) |
| Loans and advances to customers | 450 | (34) | - | 416 |
| Deferred foreign exchange differences | (342) | (92) | - | (434) |
| Other items | (67) | (202) | - | (269) |
| Tax losses carried forward | 1,172 | (897) | - | 275 |
| **Total** | **48** | **(637)** | **0** | **(590)** |

## 32. Other liabilities

| | 2014 | 2013 |
|---|---|---|
| Excess payments on lease and loan agreements | 4,791 | 8,857 |
| Unsettled securities trading | 2,356 | 2,710 |
| Withholding tax | 2,329 | 4,256 |
| Accounts payable | 102 | 484 |
| Contribution to the Depositors' and Investors' Guarantee Fund | 260 | 270 |
| Tax on liabilities of financial institutions | 2,989 | 3,283 |
| Current tax liabilities | 7,953 | 8,325 |
| Non controlling interests - Funds | 1,693 | 945 |
| Sundry liabilities | 4,561 | 5,460 |
| **Total** | **27,034** | **34,589** |

Unsettled securities transactions 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 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 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 requires that the Bank make additional contributions to the Fund if so jointly 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 a liability as at 31 December 2014 amounts to ISK 260 million to be paid no later than 1 March 2015 (31 December 2013: ISK 270 million).

## 33. Equity

*Share capital*

The total number of ordinary shares authorised and issued by the Bank at year-end 2014 were 24 billion, but outstanding shares were 23,7 billion, 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.

*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.

*Share-based payment reserve*

In February 2014, the Bank completed the allocation of the remainder of own shares received from LBI hf. in 2013, in accordance with LBI hf. requirements for allocation of own shares to employees and a resolution passed at a shareholder's meeting of the Bank in July 2013. The net result of the total 500 million shares being received by the Bank and allocated to employees, and partly repurchased by the Bank for settlement of tax obligations and pension liabilities, is that the Bank's current and former employees now own 187 million shares in total (0.78%) and the Bank itself holds 313 million of own shares (1.30%).

*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.

## 33. Equity (continued)

*Dividend*

At the Annual General Meeting of the Bank for the operating year 2013 held on 19 March 2014, shareholders approved the Board's proposal to pay dividends to shareholders in the amount of ISK 0.84 per share for the year 2013. Dividend was paid on 26 March 2014 to parties registered in the shareholders' registry on 19 March 2014. The dividend payment amounted to ISK 19,897 million on the outstanding shares.

*Restriction of dividend payments*

Certain restrictions on dividend payments originally set by LBI hf. have been abolished under the agreement between the Bank and the Winding-up Board of LBI hf. on extension of the repayment schedule of the secured foreign currency bonds issued by the Bank to LBI hf. The agreement became effective as of 4 December 2014 under the Amendment and Restatement Agreement and the amendments to it from 12 June 2014. Dividend payments under this agreement are permissible while the Bonds are outstanding provided that the capital adequacy ratio as reported in the latest annual or interim financial statements of the Group, prior to the decision to make dividend payments (and after giving effect to such dividend payment), is not less than the total minimum requirement as determined by the Financial Supervisory Authority in Iceland (FME) in accordance with the relevant Icelandic law and regulation from time to time. Furthermore, it is required that the Bonds are not and will not as a result of such dividend payment become subject to an Event of Default and that any such dividend payment is to be made solely in Icelandic króna (ISK).

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.

## Other notes

### 34. Earnings per share

| Profit for the year | 2014 | 2013 |
|---|---|---|
| Profit for the year attributable to owners of the Bank | 29,737 | 28,750 |

Diluted earnings per share are calculated by adjusting the weighted average number of ordinary shares outstanding to assume conversion of all dilutive potential ordinary shares.

| Number of shares | | |
|---|---|---|
| Number of ordinary shares outstanding at beginning of year | 24,000 | 24,000 |
| Average number of own shares | (324) | (345) |
| **Weighted average number of shares outstanding** | **23,676** | **23,655** |
| | | |
| **Basic and diluted earnings per share from continuing operations** | **1.26** | **1.22** |

The Bank's basic and diluted earnings per share are equal as the Bank has not issued any options, warrants, convertibles or other potential sources of dilution.

### 35. Litigation

The Bank and its subsidiaries are from time to time party to litigation cases which arise in the ordinary course of business. Some of these cases are material in the sense that management considers that they may have a significant impact on the amounts disclosed in the Group's financial statements and are not comparable to other, previously closed, cases.

#### Material cases open at year-end 2014

Recalculation of foreign currency indexed loans

1) In December 2013, a company brought two lawsuits against the Bank demanding recalculation of previous recalculations of a foreign currency indexed loan in accordance with Supreme Court judgements No. 600/2011 and No. 464/2012. The plaintiff argues that conditions established for rejecting the main principles of laws on claims on the claim holder's right to additional payment are met in the case. As such, contractual interest should be paid in accordance with final receipts rather than Central Bank interest rates. Landsbankinn rejected the company's claim, referring, inter alia, to Supreme Court judgement No. 463/2013 which concluded that conditions for granting the exception had not been met since there was no difference in the comparative position between the parties and the additional claim would not cause a serious disruption of a company's financial position comparable to the impact unexpected demands for additional payment would have on an individual or small enterprise. On 7 November 2014, Landsbankinn was acquitted in both cases by the District Court. The District Court concluded that the company had not shown that the Bank's insistence on Central Bank interest rates had had such a material and unexpected impact on its financial position that the Bank should absorb the risk arising from the imbalance between contractual rates and Central Bank rates. The cases have been appealed to the Supreme Court.

Inflation-indexation of financial obligations

2) In January 2013, a customer commenced litigation against the Bank, seeking acknowledgement of the unlawfulness of a consumer price indexation of a bond issued by him to the Bank and that it is not permissible for the Bank to revalue the principle amount of the bond on a monthly basis in accordance with the consumer price index. The EFTA Court handed down its advisory opinion on the case on 24 November 2014. As regards Directive 87/102/EEC, on Consumer Credit, the EFTA Court finds that when a credit agreement is linked to a CPI, it is not compatible with the Directive to calculate the total cost of the credit and the annual percentage rate of charge on the basis of 0% inflation if the known rate of inflation at the time of the credit agreement is not 0%. It is for the national court to assess, taking account of all the circumstances of the case, the legal consequences of and the remedies for such incorrect information, provided that the level of protection established by the Directive, as interpreted by the Court, is not compromised. As regards Directive 93/13/EEC on Unfair Terms in Consumer Contracts, the EFTA Court finds that the Directive does not generally prohibit contractual terms on the indexation of loans in contracts between a lender and a consumer. It is for the national court to assess whether the term at issue is unfair. The District Court will now review the EFTA Court's opinion and establish, based on Icelandic law, whether and to what extent it impacts judgement in the case. On 22 December 2014, the District Court rejected the plaintiff's request to appoint an assessor to the case; the plaintiff has referred that judgement to the Supreme Court. It is unclear when a final ruling might be expected in the case. It should be noted that on 6 February 2015, the District Court of Reykjavík ruled in two cases, in which similar issues were disputed, that it had not been established that information disclosure to the borrowers by relevant financial institutions had impacted the borrowers' interests to such an extent as to nullify the indexation provisions of the disputed loan contracts.

## 35. Litigation (continued)

Transfer of assets and liabilities from Landsbanki Íslands to Landsbankinn

3) In November 2012, Landsbankinn Guernsey Ltd. commenced litigation against the Bank et al, concerning money market deposits placed with Landsbanki Íslands (now LBI). The District Court acquitted the Bank of the plaintiff's claims on 19 December 2014 and concluded that the deposits should not have been classified as obligations to be transferred to Landsbankinn in accordance with the decisions of the Financial Supervisory Authority dated 9 October and 11 November 2008. The case is expected to be referred to the Supreme Court.

Investigation of the Icelandic Competition Authority into lending terms

4) In March 2013, the Icelandic Competition Authority submitted to the Bank its preliminary assessment concerning certain preferential terms and conditions offered during 2004-2010 by Landsbanki Íslands hf. (now LBI) and, subsequently, by the Bank in 2004 to 2010 to clients for retail banking services, in particular for household mortgage loans. In June 2013, the Bank gave its response and refuted allegations of a breach of competition rules. The Bank does not have information as to whether the Competition Authority will take further action in the case but has expressed willingness to collaborate in the matter. On 1 July 2014, the Authority notified the Bank that a decision in the case would not be forthcoming until the first six months of 2015.

Claim for damages by a payment card company

5) In June 2013, a payment card company commenced litigation against the Bank and other financial undertakings claiming tort liability in an amount of around ISK 1,2 billion plus interest. The plaintiff argues that the defendants are liable in tort for alleged violation of competition rules. The Bank refutes the allegations and the claims. The time limit for the Bank to submit its defence has not expired.

### Material cases closed in 2014

Foreign currency indexation of financial obligations

6) In December 2012, a limited liability company commenced litigation against the Bank, arguing that loans taken by the company should be recalculated as loans denominated in Icelandic krona unlawfully indexed to foreign currency. The Bank argued that the loans were repaid in foreign currencies and should thus be classified as foreign currency loans. On 25 June 2013, the District Court acquitted the Bank of the company's claim. The judgement was based, inter alia, on the consideration that overall fulfilment of the loan agreements was to such a large degree based on foreign currency transactions that the loans must be considered to constitute foreign currency loans. The Supreme Court upheld this ruling on 6 March 2014.

7) In December 2012, a limited liability company commenced litigation against the Bank, demanding that a loan agreement be judged to be an ISK-denominated loan, unlawfully indexed to foreign currency. The loan agreement referred to CHF, equivalent to a specific amount in ISK. Landsbankinn argued the loan was a foreign currency loan, inter alia, because the company had paid instalments for the most part in foreign currency. On 18 December 2014, the Supreme Court ruled in the case that the loan constituted a loan in ISK, illegally indexed to foreign currency.

### Miscellaneous

8) In October 2012, Kaupþing hf. commenced litigation against Landsbréf hf., Landsbanki Structured Finance III and Landsvaki hf. Kaupþing's claim was based on a derivative contract between Kaupþing and Landssjóður. On 18 December 2014, the case was withdrawn following the conclusion of a settlement.

9) In December 2012, 14 foreign banks commenced litigation against the Bank demanding that the Bank pay damages for alleged non-fulfilment of obligations provided for in two declarations issued in relation to a pledge of deposits on bank accounts with Landsbanki Íslands hf. (now LBI) by an Icelandic holding company to guarantee payment of loans the company borrowed from the foreign banks. The Supreme Court acquitted the Bank in October 2014.

10) In May 2014, the Icelandic Competition Authority sent to the Bank its preliminary assessment in a case concerning alleged breaches of competition rules by certain companies in the construction market. The investigation period extended from 2008 to March 2011. From 2009, one of the companies concerned, Húsasmiðjan ehf., was owned by Eignarhaldsfélagið Vestia ehf., then a subsidiary of the Bank. Eignarhaldsfélagið Vestia ehf. was sold to Framtakssjóður Íslands slhf. (FSÍ) in August 2010. In December 2011, FSÍ sold Húsasmiðjan to Hömlur ehf., a subsidiary of the Bank, but the entire operations of the company were transferred to a third company which was not a part of the Group. The name of the legal entity sold to Hömlur was changed to Holtavegur 10 ehf. On 9 July 2014, the Competition Authority closed the case as regards the Bank and the Group with a settlement concluded with Holtavogur ehf.

11) In March 2013, the Icelandic Competition Authority submitted to the Bank its preliminary assessment and conclusions in a case concerning the Bank's holdings in payment card companies Borgun hf. and Valitor hf. and, in particular, the way in which these companies had determined the interchange fees for payment cards. The case was closed in December 2014 with a settlement between the Bank and the Competition Authority under which the Bank acknowledged that certain practices on the payment card market during 2007-2009 had been contrary to competition rules. The Bank agreed to pay a fine of ISK 450 million and to undertake certain measures aimed at enhancing competition on the payment card market.

## 36. 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 on 31 December were as follows:

| | 2014 | 2013 |
|---|---|---|
| Less than one year | 124 | 123 |
| Between one and five years | 303 | 312 |
| More than five years | 248 | 247 |
| **Total** | **675** | **682** |

## 36. Leasing (continued)

### 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 on 31 December were as follows:

| | 2014 | 2013 |
|---|---|---|
| Less than one year | 36 | 167 |
| Between one and five years | 244 | 247 |
| More than five years | - | 22 |
| **Total** | **280** | **436** |

### 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 2014 | Gross investment in finance lease | Future finance income | Present value of minimum lease |
|---|---|---|---|
| Less than one year | 1,173 | (82) | 1,091 |
| Between one and five years | 401 | (31) | 370 |
| More than five years | 73 | (6) | 67 |
| **Total** | **1,647** | **(119)** | **1,528** |
| **At 31 December 2013** | | | |
| Less than one year | 2,748 | (268) | 2,480 |
| Between one and five years | 4,753 | (368) | 4,385 |
| More than five years | 621 | (48) | 573 |
| **Total** | **8,122** | **(684)** | **7,438** |

Unguaranteed residual value at year-end 2014 is nil (2013: nil).

## 37. 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 2014, financial assets managed by the Group amounted to ISK 118 billion (2013: ISK 111 billion). Custody accounts amounted to ISK 844 billion (2013: ISK 845 billion).

## 38. Interest in subsidiaries

The main subsidiaries held directly or indirectly by the Group as at 31 December 2014 were as detailed in the table below. This includes those subsidiaries that are most significant in the context of the Group's business. See Note 3.1 (a) for further information on the accounting policies governing the consolidation of subsidiaries.

### Main subsidiaries as at 31 December 2014

| Company | Ownership interest | Activity |
|---|---|---|
| Eignarhaldsfélag Landsbankans ehf. (Iceland) | 100% | Holding company |
| Landsbréf hf. (Iceland) | 100% | Management company for mutual funds |
| Hömlur ehf. (Iceland)* | 100% | Holding company |
| Landsbanki Holdings UK plc. (United Kingdom) | 100% | Holding company in liquidation |

*Hömlur ehf. is a parent of twelve subsidiaries, including Ístak hf., which are neither individually nor combined significant in the context of the Group's business.

The Group does not have significant restrictions on its ability to access or use its assets and settle its liabilities other than those resulting from the supervisory framework. The Group did not have any material non-controlling interests as at 31 December 2014.

## 39. Consolidated structured entities

Structured entities are assessed for consolidation in accordance with the accounting policy set out in Note 3.2. Financial investments under control are presented in the following balance sheet lines:

| Assets | 2014 | 2013 |
|---|---|---|
| Bonds and debt instruments | 785 | 830 |
| Equities and equity instruments | 2,172 | 1,074 |
| Other assets | 10 | - |

| Liabilities | 2014 | 2013 |
|---|---|---|
| Non controlling interests - Funds | 1,693 | 945 |

The Bank holds majority of the units in the investment funds managed by Landsbréf. These funds are consolidated like subsidiaries in the Bank's Consolidated Financial Statements, with the exception that minority interests are recognised among Other liabilities instead of Equity. The reason for this distinction is that the holders of the units may request redemption of their shareholding and therefore the units do not meet the requirements of the definition of equity.

## 40. Unconsolidated structured entities

Where the Group acts as an agent for the investor, it does not consolidate the investment funds. When the Group holds investments in unconsolidated investment funds, they are classified as financial investments designated at fair value through profit or loss. The fair value of these investments represents the Group's maximum exposure to loss from its investments into such unconsolidated investment funds.

| Type of structured entity | Nature and purpose | Interest held by the Group | Total assets |
|---|---|---|---|
| Investment funds | To generate fees from managing assets on behalf of third party investors. | Investment in units issued by fund | 53,900 |
| | These vehicles are financed through the issue of units to investors | Management fees | |

The following table shows out an analysis of the carrying amounts of interests held by the Group in unconsolidated structured entities. The Group's maximum exposure to loss is the carrying amount of the assets held.

| Investment securites | Carrying amount |
|---|---|
| Investment funds | 1,884 |
| **Total** | **1,884** |

## 41. Guarantees / Off balance sheet exposures within the Group

These guarantees are provided in the normal course of banking business. The Group's maximum exposures to credit risk as at 31 December 2014 were as follows:

| Off-balance sheet exposure 31 December 2014 | Carrying amount |
|---|---|
| Financial guarantees | 1,877 |
| Undrawn overdraft/credit card facilities | 6,633 |

## 42. Related party transactions

### Related parties

The Icelandic State Treasury, on behalf of the Icelandic State, holds 98% 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. Further details about the main subsidiaries can been seen in Note 38, Interest in subsidiaries.

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 and Managing Directors. The Minister of Finance and the members of the Board of Directors of ISFI also meet the definition of related party.

## 42. Related party transactions (continued)

### Transactions with related parties

### 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 57.

### Transactions with other related parties

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:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Loans in ISK million** | **Balance as at 31 December** | **Highest amount outstanding during the period** | **Balance as at 31 December** | **Highest amount outstanding during the period** |
| Key management personnel | 95 | 155 | 108 | 131 |
| Parties related to key management personnel | 62 | 165 | 136 | 224 |
| Associates | 17,583 | 56,357 | 47,037 | 63,892 |
| Other | 11 | 17 | 17 | 18 |
| **Total** | **17,751** | **56,694** | **47,298** | **64,265** |

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 during the period. There are no leasing transactions between related parties during 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:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Deposits in ISK million** | **Balance as at 31 December** | **Highest amount outstanding during the period** | **Balance as at 31 December** | **Highest amount outstanding during the period** |
| Key management personnel | 55 | 123 | 49 | 116 |
| Parties related to key management personnel | 23 | 74 | 24 | 116 |
| Associates | 304 | 18,107 | 13,030 | 21,234 |
| Other | 1 | 2 | 1 | 1 |
| **Total** | **383** | **18,306** | **13,104** | **21,467** |

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 as at 31 December 2014** | **Balance as at 31 December 2013** |
|---|---|---|
| Associates | - | 520 |
| **Total** | **0** | **520** |

## 42. Related party transactions (continued)

### Transactions with other related parties (continued)

### Effect on income statement:

The following table presents the total amount of interest income and expense recognised by the Group in relation to key management personnel and parties related to them and associates of the Group:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Interest income and expense** | **Interest income** | **Interest expense** | **Interest income** | **Interest expense** |
| Key management personnel | 8 | 2 | 7 | 4 |
| Parties related to key management personnel | 9 | 1 | 9 | 1 |
| Associates | 1,186 | 18 | 3,078 | 106 |
| Other | 2 | - | 1 | - |
| **Total** | **1,205** | **21** | **3,095** | **111** |

The following table presents the total amount of other income and expense recognised by the Group in realation to key management personnel and parties related to them and associates of the Group:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Other income and expense** | **Other income** | **Other expense** | **Other income** | **Other expense** |
| Associates | - | 613 | - | 371 |
| **Total** | **0** | **613** | **0** | **371** |

All of the above transactions were made in the ordinary course of business and substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with the third party counterparties.

The following table presents the total amount of compensation to Directors, CEOs and Managing Directors for the year 2014:

| **Salary and benefits for the year 2014** | **Salary and benefits*** | **Equity-settled employee share-based payment** | **Defined contri-butions**** | **Total** | **Number of shares** |
|---|---|---|---|---|---|
| Tryggvi Pálsson, Chairman of the Board of the Bank | 8.4 | - | 0.8 | 9.2 | - |
| Eva Sóley Guðbjörnsdóttir, Vice-chairman of the Board of the Bank | 6.3 | - | 0.6 | 6.9 | - |
| Danielle Pamela Neben, Member of the Board of the Bank | 5.4 | - | 0.4 | 5.8 | - |
| Helga Björk Eiríksdóttir, Member of the Board of the Bank | 5.4 | - | 0.5 | 5.9 | - |
| Kristján Þórarinn Davíðsson, Member of the Board of the Bank | 5.4 | - | 0.5 | 5.9 | - |
| Jón Sigurðsson, Member of the Board of the Bank | 5.4 | - | 0.5 | 5.9 | - |
| Jóhann Hjartarson, Member of the Board of the Bank | 4.1 | - | 0.4 | 4.5 | - |
| Þórdís Ingadóttir, former Member of the Board of the Bank | 1.4 | - | 0.1 | 1.5 | - |
| Tinna Laufey Ásgeirsdóttir, alternate director of the Board of the Bank | 0.2 | - | - | 0.2 | - |
| Helga Loftsdóttir, Alternate Director of the Board of the Bank | 0.2 | - | - | 0.2 | - |
| Steinþór Pálsson, CEO of the Bank | 18.5 | 2.1 | 3.6 | 24.2 | 0.3 |
| Seven Managing Directors of the Bank's divisions | 193.5 | 19.4 | 39.9 | 252.8 | 2.4 |
| **Total** | **254.2** | **21.5** | **47.3** | **323.0** | **2.7** |

*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 2014 the total monthly salary and benefits of the current CEO of the Bank amounted to ISK 1.5 million and the average monthly salary and benefits of current Managing Directors of the Bank's divisions amounted to ISK 2.3 million.

## 42. Related party transactions (continued)

### Compensation to Directors, CEOs and Managing Directors (continued)

The following table presents the total amount of compensation to Directors, CEOs and Managing Directors for the year 2013:

| Salary and benefits for the year 2013 | Salary and benefits* | Equity-settled employee share-based payment | Defined contri-butions** | Total | Number of shares |
|---|---|---|---|---|---|
| Tryggvi Pálsson, Chairman of the Board of the Bank | 5.9 | - | 0.6 | 6.5 | - |
| Eva Sóley Guðbjörnsdóttir, Vice-chairman of the Board of the Bank | 4.4 | - | 0.4 | 4.8 | - |
| Þórdís Ingadóttir, Member of the Board of the Bank | 5.4 | - | 0.4 | 5.8 | - |
| Danielle Pamela Neben, Member of the Board of the Bank | 2.3 | - | 0.2 | 2.5 | - |
| Helga Björk Eiríksdóttir, Member of the Board of the Bank | 3.8 | - | 0.3 | 4.1 | - |
| Kristján Þórarinn Davíðsson, Member of the Board of the Bank | 3.8 | - | 0.3 | 4.1 | - |
| Jón Sigurðsson, Member of the Board of the Bank | 4.5 | - | 0.4 | 4.9 | - |
| Tinna Laufey Ásgeirsdóttir, Alternate Director of the Board of the Bank | 0.2 | - | - | 0.2 | - |
| Helga Loftsdóttir, Alternate Director of the Board of the Bank | 1.4 | - | 0.1 | 1.5 | - |
| Gunnar Helgi Hálfdánarson, former Chairman of the Board of the Bank | 2.4 | - | 0.2 | 2.6 | - |
| Sigríður Hrólfsdóttir, former Vice-chairman of the Board of the Bank | 1.8 | - | 0.1 | 1.9 | - |
| Ólafur Helgi Ólafsson, former Member of the Board of the Bank | 1.5 | - | 0.1 | 1.6 | - |
| Andri Geir Arinbjarnarson, former Member of the Board of the Bank | 1.7 | - | 0.1 | 1.8 | - |
| Steinþór Pálsson, CEO of the Bank | 18.0 | 4.2 | 4.0 | 26.2 | 0.2 |
| Seven Managing Directors of the Bank's divisions | 161.8 | 29.2 | 38.8 | 229.8 | 1.6 |
| **Total** | **218.9** | **33.4** | **46.0** | **298.3** | **1.8** |

*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 2013 the total monthly salary and benefits of the current CEO of the Bank amounted to ISK 1.5 million and the average monthly salary and benefits of current Managing Directors of the Bank's divisions amounted to ISK 1.9 million.

### 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 2014. 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.

## 43. Events after the reporting period

No events have arisen after the reporting period of these financial statements that require amendments or additional disclosures in the consolidated financial statements for the year ended 31 December 2014.

## Capital management

### 44. Capital management

The Group's capital management policies and practices ensure that the Group has sufficient capital to cover the risks associated with its activities on a consolidated basis. The capital management framework of the Group comprises four interdependent areas: capital assessment, risk appetite/capital target, capital planning, and reporting/monitoring. The Group regularly monitors and assesses its risk profile in the most important business areas on a consolidated basis 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 Group's capital requirements are defined in Icelandic law and regulations, on the one hand, and by the Icelandic Financial Supervisory Authority (FME), on the other. The requirements are based on the European legal framework for capital requirements (CRD) implementing the Basel framework. The regulatory minimum capital requirement under Pillar I of the Basel framework is 8% of risk-weighted assets (RWA) for credit risk, market risk and operational risk. In conformity with Pillar II of the Basel framework, the Bank annually assesses its own capital needs through the Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP results are subsequently reviewed by the FME in the Supervisory Review and Evaluation Process (SREP).

In the latest SREP, based on data from 31 December 2013, the FME determined the minimum capital requirement for the Group to be 15.8% of RWA (31.12.2012: 16.7% of RWA), consisting of the 8% regulatory capital requirement under Pillar I and a 7.8% capital requirement under Pillar II. Moreover, forthcoming Icelandic legislation, implementing the new EU CRD IV capital requirements, is expected to require the Group to hold capital buffers in addition to the existing capital requirements.

The Group intends to maintain a total capital ratio above the aggregate of the current SREP at each time and the new forthcoming capital buffers under CRD IV. Notwithstanding legal and regulatory requirements, the Group has set a target for total capital ratio of at least 20% of RWA.

### 45. Capital base and capital adequacy ratio

The Group's equity as at 31 December 2014 amounted to ISK 250,803 million (31.12.2013: ISK 241,359 million), equivalent to 22.8% (31.12.2013: 21.0%) 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 29.5% at 31 December 2014 (31.12.2013: 26.7%). According to the Act, this ratio may not fall below 8%.

| Capital base | 2014 | 2013 |
|---|---|---|
| Share capital | 23,687 | 23,618 |
| Share premium | 121,275 | 120,700 |
| Reserves | 6,000 | 7,046 |
| Retained earnings | 99,841 | 90,002 |
| Non-controlling interests | - | (7) |
| **Total equity** | **250,803** | **241,359** |
| Intangible assets | (1,225) | (585) |
| Deferred tax assets | (83) | - |
| **Tier 1 capital** | **249,495** | **240,774** |
| Deduction from original and additional own funds | - | (3,865) |
| **Capital base** | **249,495** | **236,909** |
| **Risk-weighted assets** | | |
| Credit risk | 665,167 | 684,655 |
| Market risk | 83,601 | 99,763 |
| Operational risk | 96,836 | 104,500 |
| **Total risk-weighted assets** | **845,604** | **888,918** |
| Tier 1 capital ratio | 29.5% | 27.1% |
| Capital adequacy ratio | 29.5% | 26.7% |

### 46. 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 Group 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 Group 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.

## 46. Economic capital framework (continued)

The framework covers the following risk types: credit risk, market risk, currency risk, operational risk, concentration risk, interest rate risk in the non-trading book, inflation risk, legal risk and business risk.

The following summarises how the Group calculates its EC for these risks:

Credit risk:
The credit risk EC 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 risk in the trading book is calculated using the standardised measurement method of the Basel framework, i.e. EC equals the Bank's capital requirements for interest rate risk. However, market risk EC for equity risk is calculated using the following risk weights:
• 290% for exchange traded equity exposures.
• 370% for all other equity exposures.

Currency risk:
For FX positions a VaR-model is used to calculate EC. 1-day 99% VaR as well as stressed VaR (SVaR) are calculated, scaled to a 10-day value and multiplied by 3 in accordance with the internal model approach in the Basel framework. Stressed VaR is calculated from the worst case of the previous 250 days. EC for FX-risk equals the sum of the one-year 99.9% VaR and SVaR.

Concentration risk:
EC for single name concentration is calculated by adjusting for the granularity and non-homogeneity in the loan 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.

Inflation risk:
Inflation risk EC is equal to the loss in economic value of inflation linked assets and liabilities resulting from a shift in the one year inflation during the next 12 months. The magnitude of the shift is defined as the 99.9% percentile of the one year inflation, estimated using a time series model.

Operational risk:
EC for operational risk is calculated using the basic indicator approach, which means that it equals the Group's capital requirement.

Business risk:
EC for business risk is calculated using an internal model, which is based on the volatility of the Group's income, before profit or loss due to any other material risk.

Legal and regulatory risk:
EC for legal and regulatory risk is calculated by adding the potential loss of on-going disputes. The significance of a dispute is assessed by its claim value and status within the court system.

## 47. Economic capital by risk type

The Group's main focus regarding market risk in the past year was to reduce exposure to unlisted equities and that will be ongoing in 2015. As a result, EC for market risk decreased significantly in 2014. The Group introduced EC for inflation risk at year-end. EC for credit risk decreased due to lower probability of default and improved collateralisation. More significant disputes against the Group causes increased estimate of Economic Capital due to Legal and regulatory risk.

| Economic capital ISK million | 2014 | 2013 |
|---|---|---|
| Credit risk - Loans to customers and credit institutions | 60,401 | 63,770 |
| Credit risk - Other assets | 3,659 | 4,379 |
| Market risk | 9,403 | 12,124 |
| Currency risk | 1,946 | 2,728 |
| Operational risk | 7,747 | 8,360 |
| Single name concentration risk | 7,093 | 7,736 |
| Industry concentration risk | 4,067 | 3,175 |
| Inflation risk | 5,139 | - |
| Interest rate risk | 9,345 | 9,925 |
| Business risk | 3,873 | 4,180 |
| Legal and regulatory risk | 6,697 | 5,711 |
| **Total** | **119,370** | **122,088** |
| EC/RWA | 14.1% | 13.7% |

### 47. Economic capital by risk type (continued)

| Credit risk at 31 December 2014 | Weighted average Probability of default (PD) | Weighted average Loss given default (LGD)* | Exposure at default (EAD) | Economic capital (EC) |
|---|---|---|---|---|
| Financial institutions | 0.1% | 45.0% | 50,060 | 828 |
| Public entities | 0.5% | 44.4% | 17,661 | 474 |
| Individuals | 4.1% | 31.1% | 263,099 | 10,040 |
| Corporates | 5.8% | 42.7% | 556,742 | 49,059 |
| **Total** | **4.8%** | **39.3%** | **887,562** | **60,401** |

*Foundation IRB LGD is used for EC calculations and risk management. The Group has also implemented an internal LGD model for impairment use.

| Credit risk at 31 December 2013 | Weighted average Probability of default (PD) | Weighted average Loss given default (LGD) | Exposure at default (EAD) | Economic capital (EC) |
|---|---|---|---|---|
| Financial institutions | 0.2% | 45.0% | 59,820 | 1,421 |
| Public entities | 0.9% | 45.4% | 15,842 | 553 |
| Individuals | 4.4% | 33.0% | 243,616 | 8,690 |
| Corporates | 5.5% | 44.8% | 603,202 | 53,107 |
| **Total** | **4.7%** | **41.7%** | **922,480** | **63,771** |

## Risk management

### 48. Risk management structure

#### Risk committees

The Group's risk management governance structure as at year-end 2014 is as follows:

**Board of Directors**

**Supervision by the Board of Directors and its sub-committees:**

- Audit Committee
- Remuneration Committee
- Risk Committee
- Strategic Development Committee

**Key risk management bodies and committees**

| Committee | Chair | Other members |
|---|---|---|
| Executive Board | CEO | Managing directors |
| Risk & Finance Committee | CEO | CFO, CRO, Head of Legal Department, MD of Operations & IT |
| Credit Committee | CEO | CRO, MD of Corporate Banking, MD of Personal Banking |
| Operational Risk Committee | CRO | MD of Personal Banking, MD of Operations & IT, MD of Corporate Development & HR, Head of Compliance |

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 Executive Board, the Risk & Finance Committee and the Credit Committee.

The Credit Committee deals with credit risk – individual credit decisions, credit limits on individual customers and credit risk policy issues - while the Risk & Finance Committee covers primarily market risk, liquidity risk and legal risk. The Risk & Finance Committee monitors all of 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 Board 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 not being considered in other standing committee. The Operational Risk Committee is a forum for discussions and decisions on key risk issues and review of the effective implementation of the operational risk framework.

#### Risk Management Division

The Bank's Risk Management Division is responsible for the Group's risk management framework. Subsidiaries of the Bank have their own risk management functions and the Risk Management Division receives information on exposures from the subsidiaries and collates them into Group exposures. The Risk Management Division is also responsible for comprehensive risk reporting on risk positions to various departments and committees and supervisory authorities.

**48. Risk management structure (continued)**

The Risk Management Division is comprised of four departments.

• The Credit Management Department is responsible for risk assessment and oversight of credit decisions. The department has veto rights regarding credit applications from customers with exposures exceeding the credit limits of individual business units and customers who have been classified as on the watch list in the Early Warning System (see Note 53). Decisions exceeding the confirmation limits of the Risk Management Division are referred to the Group's Credit Committee.

• The Credit Risk & Economic Capital Department is responsible for providing the Group with internal models and credit monitoring systems as well as related processes to measure and monitor credit risk and economic capital. The Department also supports the implementation of such models and processes within the Bank. In addition, the Department is responsible for credit risk, economic capital and impairment analysis and reporting within the Bank.

• The Market Risk Department is responsible for measuring and monitoring market risk, liquidity risk and interest rate risk in the Group's banking book. Market Risk 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 Bank as well as providing limit monitoring for pension funds under management by the Bank.

• The Operational Risk Department is responsible for ensuring that operational risks are monitored and that the Bank implements and maintains an effective operational risk management framework. The department assists the Bank's managers with operational risk self-assessment and reporting and analysis of operational incidents, and oversees continuity plans. The Operational Risk Department leads the work on the Bank's certification under the ISO 27001 standard for information security.

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. Compliance also concentrates on Group adherence to codes of ethics and on limiting market abuse, minimising conflicts of interest and ensuring best practice. Compliance is one of the Group's support functions and is integral to its corporate culture.

Group Internal Audit is an independent, objective assurance and consulting activity designed to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of its risk management, controls, and governance processes. Group Internal Audit determines whether the risk management framework, control, and governance processes as designed and represented by management are adequate and functioning, and thus supports the Group accomplish its objectives.

**49. Risk appetite**

The Group's risk appetite has been reviewed, revised and implemented for 2015. The Group's risk policy is as follows:

Landsbankinn provides universal financial services to customers. For this purpose, the Group has set itself objectives regarding financial position, asset quality, exposures and a satisfactory long-term profitability. In the pursuit of its goals, the Bank only takes on risks that it understands, is able to evaluate and manage. Landsbankinn aims to be comparable with leading banks in the Nordic countries in similar fields.

The Bank seeks to maintain solid business relationships, having regard for its own position as well as that of customers at each time and with due regard for any internal connections between customers. Landsbankinn pursues long-term business relationships and avoids being linked to transactions that might damage its reputation.

The Bank seeks to ensure diversified and sound financing and a sustainable risk profile in its balance sheet. The Bank has set internal limits that provide for a strong capital and liquidity position which, along with active risk management, ensure long-term profitability and strong standing. In this manner, the Bank minimises fluctuation in its operations and is well positioned to withstand stress scenarios.

Landsbankinn's corporate culture is characterised by professionalism and processes that support a high level of risk management. Managers are responsible for monitoring and managing risk within their units. Decisions are based on a thorough and professional discussion of major advantages having the long-term interests of Landsbankinn and its customers in mind. Efficient follow-up on decisions and risk monitoring are integral to the Bank's operations.

**50. Risk assessment**

Risk is inherent in the Group'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 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 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 detected, measured, monitored and effectively managed. Exposure to risks is managed to ensure that it will remain within limits and the risk appetite adopted by the Group will comply with regulatory requirements. In order to ensure that 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 asset portfolio which are covered in more detail under each risk type.

## 50. Risk assessment (continued)

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
· Liquidity risk
· Market risk
  -Currency risk
  -Interest rate risk
  -Other market risk
· Operational risk

The table below provides a link between the Group's business units and the principal risks that they are exposed to. The significance of risk is assessed within the context of the Group as a whole and is measured based on allocation of the regulatory capital within the Group.

| Principal risk | Personal Banking | Corporate Banking | Markets | Treasury |
|---|---|---|---|---|
| Credit risk | High | High | Low | Low |
| Operational risk | Medium | Medium | High | Medium |
| Market risk | Low | Low | Medium | High |
| Liquidity risk | n/a | n/a | n/a | High |

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

The above material risks are addressed in the following notes.

### Credit risk

## 51. Credit risk identification

Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

The Group's activities may give rise to risk at the time of settlement of transactions and trades. Settlement risk is the risk of loss due to the failure of an entity to honour its obligations to deliver cash, securities or other assets as contractually agreed.

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 the aforementioned

## 52. Credit risk assessment

Credit risk is measured in three main dimensions: the probability of default (PD); the loss given default (LGD) and exposure at default (EAD). 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 (PD). Internal ratings and associated PD are essential 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 following table shows the Group's internal mapping from internal rating grade to S&P rating grades:

| Internal rating grade | S&P | Lower PD | Upper PD |
|---|---|---|---|
| 10 | AAA/AA+/AA/AA- | 0.00% | 0.04% |
| 9 | A+/A/A- | 0.04% | 0.10% |
| 8 | BBB+ | 0.10% | 0.21% |
| 7 | BBB/BBB- | 0.21% | 0.46% |
| 6 | BB+/BB | 0.46% | 0.99% |
| 5 | BB- | 0.99% | 2.13% |
| 4 | B+ | 2.13% | 4.54% |
| 3 | B | 4.54% | 9.39% |
| 2 | B- | 9.39% | 18.42% |
| 1 | CCC/C | 18.42% | 99.99% |
| 0 | D | In default | In default |

### 52. Credit risk assessment (continued)

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 foundation LGD models defined in the Basel framework for the purpose of EC calculations. In addition, the Group has 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 at default is an estimate of the amount outstanding (drawn amounts plus likely future drawdowns of yet undrawn lines) in case the borrower defaults.

### 53. Credit risk control and monitoring

The Group monitors exposures to identify signs of weakness in customer earnings and liquidity as soon as possible.

To monitor customers, the Group uses - supplemental to ratings - an Early Warning System which classifies credit exposures to four credit risk groups (green, yellow, orange and red). The colour classification is the following:

• Green customers are considered as performing without signs of repayment problems;

• Yellow customers are on Watch list 1. They have temporary difficulties and may need some instalments postponed or modification of 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 supervision by Corporate Solutions and need restructuring, or are in legal collection. Restructuring options may include deferred payments, interest and/or debt forgiveness, collateral or guarantees being collected or the possible take-over of management of the customer's operations by the Group and subsequently sold.

The Credit Risk & Economic Capital Department 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.

### 54. Credit risk management and policy

The Group's credit risk management is based on active monitoring by the Board of Directors, the CEO, the Risk & Finance Committee, the Credit Committee, the credit departments within the Risk Management Division 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 and credit policy include 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 Bank's executives are responsible for the Bank's business units to execute the risk policy appropriately as the CEO is responsible for the oversight of the process as a whole.

Incremental credit authorisation levels are defined based on size of units, types of customers and lending experience of credit officers. The Group has also implemented industry policies to the credit decision process. Credit decisions exceeding authorisation levels of business units are subject to confirmation by Credit Management, a department within 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 holds the highest credit authorisation within the Bank.

### 55. 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 and is standard market practice.

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

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 Group's credit policy. 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, inventory 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 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 collateral and may require additional collateral in accordance with the underlying loan agreements.

### 55. Credit risk mitigation (continued)

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

The Group includes all collateral to which a value is assigned in accordance with its internal procedures. Guarantees are included if they imply lower risk weights than the original exposure. In addition, collateral is volatility-adjusted (by means of a haircut) in order to take into account price volatility and the expected costs of repossession and sale of the pledge.

#### 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 meet certain conditions set by the Group. The Group also enters into standard International Swaps and Derivatives Association (ISDA) master netting agreements with foreign counterparties and similar general netting agreements with domestic counterparties. Commensurate collateral and margin requirements are in place 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 both derivatives exposures and collateral value and calculates a credit equivalent value for each derivative intraday. It also issues margin calls and manages netting agreements.

Amounts due to and from the Group are offset when the Group has a legally enforceable right to set off a recognised amount and intends either to settle on a net basis or to realise the asset and settle the liability simultaneously. External ratings are used where applicable to assist in managing the credit risk exposure of bonds. Otherwise the Group uses fair value estimates based on available information and the Group's own estimates.

### 56. Impairment process

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 on a case-by-case basis 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.

### 57. Maximum exposure to credit risk and concentration by industry sectors

The following tables show the Group's maximum credit risk exposure at 31 December 2014 and 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 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 2014** | **Financial institutions** | **Public entities*** | **Individuals** | **Fisheries** | **Construction and real estate companies** | **Holding companies** | **Retail** | **Services** | **ITC**** | **Manu-facturing** | **Agriculture** | **Other** | **Carrying amount** |
| Cash and balances with Central Bank | - | 10,160 | - | - | - | - | - | - | - | - | - | - | **10,160** |
| Bonds and debt instruments | 41 | 221,293 | - | - | 13,345 | 7,880 | - | - | - | - | - | 1,030 | **243,589** |
| Derivative instruments | 38 | - | 7 | - | - | 1 | - | - | - | - | - | 32 | **78** |
| Loans and advances to financial institutions | 49,789 | - | - | - | - | - | - | - | - | - | - | - | **49,789** |
| Loans and advances to customers | - | 13,708 | 238,932 | 156,023 | 112,880 | 42,861 | 39,118 | 56,387 | 19,798 | 28,760 | 8,751 | 1,137 | **718,355** |
| Other financial assets | 913 | 343 | 331 | - | 614 | 71 | 130 | 711 | 3 | 16,554 | 1 | 62 | **19,733** |
| **Total on-balance sheet exposure** | **50,781** | **245,504** | **239,270** | **156,023** | **126,839** | **50,813** | **39,248** | **57,098** | **19,801** | **45,314** | **8,752** | **2,261** | **1,041,704** |
| **Off-balance sheet exposure** | **2,648** | **13,688** | **22,507** | **28,197** | **33,802** | **5,150** | **11,143** | **12,652** | **3,423** | **8,974** | **525** | **706** | **143,415** |
| Financial guarantees and underwriting commitments | 45 | 611 | 572 | 7,740 | 1,917 | 3,525 | 2,240 | 2,250 | 673 | 559 | 37 | 331 | 20,500 |
| Undrawn loan commitments | - | 7,238 | - | 17,956 | 29,877 | 913 | 4,926 | 578 | 1,763 | 6,510 | 182 | 174 | 70,117 |
| Undrawn overdraft/credit card facilities | 2,603 | 5,839 | 21,935 | 2,501 | 2,008 | 712 | 3,977 | 9,824 | 987 | 1,905 | 306 | 201 | 52,798 |
| **Maximum exposure to credit risk** | **53,429** | **259,192** | **261,777** | **184,220** | **160,641** | **55,963** | **50,391** | **69,750** | **23,224** | **54,288** | **9,277** | **2,967** | **1,185,119** |
| Percentage of carrying amount | 4.5% | 21.9% | 22.1% | 15.5% | 13.6% | 4.7% | 4.3% | 5.9% | 2.0% | 4.6% | 0.8% | 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.

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

| At 31 December 2013 | Financial institutions | Public entities* | Individuals | Corporations: Fisheries | Corporations: Construction and real estate companies | Corporations: Holding companies | Corporations: Retail | Corporations: Services | Corporations: ITC** | Corporations: Manu-facturing | Corporations: Agriculture | Corporations: Other | Carrying amount |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | - | 21,520 | - | - | - | - | - | - | - | - | - | - | **21,520** |
| Bonds and debt instruments | 844 | 265,482 | - | - | 13,860 | 9,655 | - | - | - | - | - | 755 | **290,595** |
| Derivative instruments | 606 | 1 | - | - | - | - | 30 | - | - | - | - | 17 | **654** |
| Loans and advances to financial institutions | 67,916 | - | - | - | - | - | - | - | - | - | - | - | **67,916** |
| Loans and advances to customers | - | 10,015 | 201,485 | 146,302 | 127,233 | 55,814 | 35,974 | 46,617 | 19,459 | 25,337 | 7,714 | 4,518 | **680,468** |
| Other financial assets | 3,743 | 327 | 458 | 99 | 1,193 | 1 | 20 | 438 | 2 | 5 | 40 | 41 | **6,366** |
| **Total on-balance sheet exposure** | **73,109** | **297,345** | **201,943** | **146,401** | **142,286** | **65,470** | **36,024** | **47,055** | **19,461** | **25,342** | **7,754** | **5,331** | **1,067,521** |
| | | | | | | | | | | | | | |
| **Off-balance sheet exposure** | **4,568** | **16,833** | **20,818** | **20,191** | **23,508** | **8,064** | **8,249** | **14,355** | **4,088** | **7,723** | **395** | **646** | **129,438** |
| Financial guarantees and underwriting commitments | 26 | 705 | 506 | 1,666 | 2,486 | 34 | 1,738 | 5,529 | 1,012 | 593 | 28 | 40 | 14,363 |
| Undrawn loan commitments | 1,500 | 9,687 | 49 | 16,613 | 19,626 | 7,225 | 1,238 | 807 | 2,007 | 5,348 | 35 | 433 | 64,568 |
| Undrawn overdraft/credit card facilities | 3,042 | 6,441 | 20,263 | 1,912 | 1,396 | 805 | 5,273 | 8,019 | 1,069 | 1,782 | 332 | 173 | 50,507 |
| | | | | | | | | | | | | | |
| **Maximum exposure to credit risk** | **77,677** | **314,178** | **222,761** | **166,592** | **165,794** | **73,534** | **44,273** | **61,410** | **23,549** | **33,065** | **8,149** | **5,977** | **1,196,959** |
| | | | | | | | | | | | | | |
| Percentage of carrying amount | 6.5% | 26.2% | 18.6% | 13.9% | 13.9% | 6.1% | 3.7% | 5.1% | 2.0% | 2.8% | 0.7% | 0.5% | 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.

## 58. Collateral and loan-to-value by industry sectors

The loan-to-value (LTV) ratio expresses the maximum exposure of credit risk (gross carrying amount of loans and off-balance sheet items) as a percentage of the total value of collateral less a haircut. Loan-to-value is one of the key risk factors 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 are smaller buffers to protect against price falls 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 2014** | **0% - 25%** | **25% - 50%** | **50% - 75%** | **75% - 100%** | **Total** | **>100%** | **Collateral value*** | **Without collateral** | **Allowance for impairment** | **Maximum exposure to credit risk** |
| Financial institutions | - | - | - | - | - | - | - | 52,438 | - | 52,438 |
| Public entities | 36 | 86 | 198 | 807 | 1,127 | 2,767 | 437 | 23,626 | (124) | 27,396 |
| Individuals | 9,553 | 19,669 | 30,984 | 57,321 | 117,527 | 76,566 | 52,710 | 83,369 | (16,022) | 261,440 |
| Corporations | | | | | | | | | | |
| Fisheries | 3,715 | 13,169 | 22,288 | 55,862 | 95,034 | 84,487 | 59,605 | 11,184 | (6,484) | 184,221 |
| Construction and real estate companies | 903 | 2,586 | 6,605 | 25,102 | 35,196 | 107,462 | 60,068 | 11,069 | (7,046) | 146,681 |
| Holding companies | 268 | 184 | 2,021 | 11,463 | 13,936 | 30,421 | 16,525 | 6,241 | (2,590) | 48,008 |
| Retail | 168 | 2,384 | 2,250 | 8,704 | 13,506 | 32,111 | 18,744 | 7,725 | (3,080) | 50,262 |
| Services | 742 | 1,929 | 3,869 | 7,640 | 14,180 | 39,745 | 21,702 | 17,955 | (2,841) | 69,039 |
| Information, technology and communication | 47 | 65 | 61 | 50 | 223 | 15,891 | 7,032 | 7,762 | (656) | 23,220 |
| Manufacturing | 141 | 521 | 4,659 | 4,424 | 9,745 | 20,396 | 12,465 | 9,670 | (2,077) | 37,734 |
| Agriculture | 413 | 579 | 1,544 | 809 | 3,345 | 5,228 | 3,415 | 1,222 | (519) | 9,276 |
| Other | 1 | - | - | - | 1 | 1,097 | 942 | 754 | (8) | 1,844 |
| **Total** | **15,987** | **41,172** | **74,479** | **172,182** | **303,820** | **416,171** | **253,645** | **233,015** | **(41,447)** | **911,559** |
| **At 31 December 2013** | | | | | | | | | | |
| Financial institutions | - | - | - | - | - | - | - | 72,484 | - | 72,484 |
| Public entities | 24 | 60 | 209 | 1,169 | 1,462 | 4,969 | 294 | 20,550 | (134) | 26,847 |
| Individuals | 2,370 | 10,978 | 19,567 | 33,728 | 66,643 | 119,759 | 86,272 | 52,135 | (16,234) | 222,303 |
| Corporations | | | | | | | | | | |
| Fisheries | 3,758 | 6,695 | 22,194 | 35,242 | 67,889 | 99,711 | 69,672 | 7,768 | (8,874) | 166,494 |
| Construction and real estate companies | 348 | 4,546 | 5,167 | 12,397 | 22,458 | 123,137 | 66,030 | 14,138 | (8,992) | 150,741 |
| Holding companies | 495 | 245 | 1,143 | 2,709 | 4,592 | 50,895 | 34,908 | 12,384 | (3,994) | 63,878 |
| Retail | 153 | 1,050 | 1,623 | 3,604 | 6,430 | 34,635 | 17,244 | 8,851 | (5,692) | 44,223 |
| Services | 235 | 3,789 | 2,791 | 9,922 | 16,737 | 27,608 | 16,282 | 20,386 | (3,757) | 60,974 |
| Information, technology and communication | 20 | 45 | 90 | 68 | 223 | 19,107 | 8,316 | 4,853 | (636) | 23,546 |
| Manufacturing | 97 | 183 | 1,275 | 6,389 | 7,944 | 16,658 | 9,403 | 9,935 | (1,476) | 33,061 |
| Agriculture | 89 | 311 | 306 | 1,477 | 2,183 | 5,556 | 2,565 | 1,170 | (800) | 8,109 |
| Other | 2 | - | - | 112 | 114 | 522 | 231 | 4,882 | (355) | 5,162 |
| **Total** | **7,591** | **27,902** | **54,365** | **106,817** | **196,675** | **502,557** | **311,217** | **229,536** | **(50,944)** | **877,822** |

*Credit card loans and overdraft on debit cards for the year 2013 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.

## 59. Collateral types

The following tables show the collateral value less a haircut held to mitigate credit risk. Further details on the Collateral types can be seen in Note 55, Credit risk mitigation.

| As at 31 December 2014 | Real estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 1,935 | - | 35 | - | 43 | 2,013 |
| Individuals | 260,452 | 472 | 408 | 2,449 | 235 | 264,016 |
| Corporates | | | | | | |
| Fisheries | 11,123 | 155,421 | 36 | 14,623 | 23,911 | 205,114 |
| Construction and real estate companies | 97,317 | 18 | 647 | 393 | 2,655 | 101,030 |
| Holding companies | 8,168 | - | 52 | 29,975 | 482 | 38,677 |
| Retail | 13,557 | 456 | 192 | 662 | 18,968 | 33,835 |
| Services | 30,174 | 608 | 726 | 1,940 | 11,360 | 44,808 |
| Information, technology and communication | 578 | 2 | 140 | 1,002 | 5,784 | 7,506 |
| Manufacturing | 9,080 | 382 | 415 | 6,075 | 8,874 | 24,826 |
| Agriculture | 8,116 | 17 | 7 | - | 1,850 | 9,990 |
| Other | 17 | - | - | 50 | 892 | 959 |
| **Total** | **440,517** | **157,376** | **2,658** | **57,169** | **75,054** | **732,774** |

| As at 31 December 2013 | Real estate | Vessels | Deposits | Securities | Other* | Total |
|---|---|---|---|---|---|---|
| Public entities | 2,362 | - | 44 | - | 96 | 2,502 |
| Individuals | 178,271 | 456 | 1,064 | 3,686 | 21,655 | 205,132 |
| Corporates | | | | | | |
| Fisheries | 10,763 | 138,676 | 541 | 9,240 | 23,701 | 182,921 |
| Construction and real estate companies | 97,092 | 33 | 1,103 | 372 | 2,249 | 100,849 |
| Holding companies | 6,855 | - | 118 | 33,851 | 2,915 | 43,739 |
| Retail | 12,289 | 18 | 292 | 282 | 16,938 | 29,819 |
| Services | 23,713 | 891 | 357 | 1,590 | 18,558 | 45,109 |
| Information, technology and communication | 454 | 4 | 53 | 1,990 | 6,285 | 8,786 |
| Manufacturing | 9,425 | 389 | 297 | 6,510 | 3,892 | 20,513 |
| Agriculture | 5,658 | 15 | 5 | - | 556 | 6,234 |
| Other | 412 | - | - | - | 1 | 413 |
| **Total** | **347,294** | **140,482** | **3,874** | **57,521** | **96,846** | **646,016** |

* Other includes collateral like financial claims, invoices, liquid assets, vehicles, machines, aircrafts and inventories.

## 60. Loans and advances by geographical area

Geographical segmentation is based on the customer's country of residence rather than the location of the creditor.

| As at 31 December 2014 | Domestic | Foreign | Carrying amount |
|---|---|---|---|
| Loans and advances to financial institutions | 9,148 | 40,642 | 49,790 |
| Loans and advances to customers | 669,730 | 48,624 | 718,354 |
| **Total loans and advances to customers** | **678,878** | **89,266** | **768,144** |

| As at 31 December 2013 | Domestic | Foreign | Carrying amount |
|---|---|---|---|
| Loans and advances to financial institutions | 7,435 | 60,481 | 67,916 |
| Loans and advances to customers | 631,755 | 48,713 | 680,468 |
| **Total loans and advances to customers** | **639,190** | **109,194** | **748,384** |

## 61. Loans and advances credit monitoring

The following tables show the credit risk monitoring split on colour classification. Further details on the credit risk monitoring and colour classification can be seen in Note 53, Credit risk control and monitoring.

| Industry sectors as at 31 December 2014 | Green | Yellow | Orange | Red | Carrying amount |
|---|---|---|---|---|---|
| Financial institutions | 49,789 | - | - | - | 49,789 |
| Public entities | 12,878 | 718 | 96 | 16 | 13,708 |
| Individuals | 196,551 | 12,277 | 18,647 | 11,456 | 238,931 |
| Corporations | | | | | |
| Fisheries | 114,306 | 23,127 | 16,226 | 2,364 | 156,023 |
| Construction and real estate companies | 85,072 | 17,904 | 5,205 | 4,699 | 112,880 |
| Holding companies | 37,835 | 4,044 | 649 | 333 | 42,861 |
| Retail | 32,681 | 2,978 | 2,266 | 1,192 | 39,117 |
| Services | 41,556 | 8,325 | 4,788 | 1,718 | 56,387 |
| Information, technology and communication | 15,831 | 3,650 | 232 | 85 | 19,798 |
| Manufacturing | 19,209 | 3,565 | 1,131 | 4,856 | 28,761 |
| Agriculture | 7,095 | 857 | 665 | 134 | 8,751 |
| Other | 1,005 | 133 | - | - | 1,138 |
| **Total** | **613,808** | **77,578** | **49,905** | **26,853** | **768,144** |

| Industry sectors as at 31 December 2013 | Green | Yellow | Orange | Red | Carrying amount |
|---|---|---|---|---|---|
| Financial institutions | 67,916 | - | - | - | 67,916 |
| Public entities | 9,462 | 467 | 85 | 1 | 10,015 |
| Individuals | 155,486 | 13,053 | 20,746 | 12,200 | 201,485 |
| Corporations | | | | | |
| Fisheries | 111,413 | 23,905 | 3,098 | 7,886 | 146,302 |
| Construction and real estate companies | 85,624 | 19,905 | 13,950 | 7,754 | 127,233 |
| Holding companies | 44,553 | 9,121 | 893 | 1,246 | 55,813 |
| Retail | 23,712 | 5,805 | 3,424 | 3,034 | 35,975 |
| Services | 31,475 | 9,193 | 2,983 | 2,966 | 46,617 |
| Information, technology and communication | 18,420 | 784 | 163 | 92 | 19,459 |
| Manufacturing | 17,634 | 1,887 | 1,275 | 4,541 | 25,337 |
| Agriculture | 5,917 | 728 | 596 | 474 | 7,715 |
| Other | 4,279 | - | 238 | - | 4,517 |
| **Total** | **575,891** | **84,848** | **47,451** | **40,194** | **748,384** |

## 62. Credit quality of financial assets

| | Gross carrying amount | | | | | |
|---|---|---|---|---|---|---|
| **As at 31 December 2014** | 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 | 10,160 | - | - | 10,160 | - | 10,160 |
| Bonds and debt instruments | 235,568 | 8,021 | - | 243,589 | - | 243,589 |
| Derivative instruments | 78 | - | - | 78 | - | 78 |
| Loans and advances to financial institutions | 49,789 | - | - | 49,789 | - | 49,789 |
| Loans and advances to customers | 657,564 | 25,015 | 77,223 | 759,802 | (41,447) | 718,355 |
| Other financial assets | 19,733 | - | - | 19,733 | - | 19,733 |
| **Total** | **972,892** | **33,036** | **77,223** | **1,083,151** | **(41,447)** | **1,041,704** |
| **As at 31 December 2013** | | | | | | |
| Cash and balances with Central Bank | 21,520 | - | - | 21,520 | - | 21,520 |
| Bonds and debt instruments | 280,736 | 9,859 | - | 290,595 | - | 290,595 |
| Derivative instruments | 654 | - | - | 654 | - | 654 |
| Loans and advances to financial institutions | 67,916 | - | - | 67,916 | - | 67,916 |
| Loans and advances to customers | 585,526 | 54,874 | 91,012 | 731,412 | (50,944) | 680,468 |
| Other financial assets | 6,366 | - | - | 6,366 | - | 6,366 |
| **Total** | **962,718** | **64,733** | **91,012** | **1,118,463** | **(50,944)** | **1,067,519** |

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

### 63. 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. Further details on rating grades can be seen in note 52, Credit risk assessment.

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| **As at 31 December 2014** | **10-7** | **6-4** | **3-1** | **0** | **Unrated** | **Gross carrying amount** |
| Financial institutions | 49,789 | - | - | - | - | 49,789 |
| Public entities | 12,229 | 1,330 | 47 | - | 12 | 13,618 |
| Individuals | 76,490 | 97,345 | 35,635 | 266 | 3,718 | 213,454 |
| Corporations | | | | | | |
| Fisheries | 31,388 | 79,640 | 36,900 | 1,947 | 2 | 149,877 |
| Construction and real estate companies | 605 | 55,037 | 51,002 | 63 | 11 | 106,718 |
| Holding companies | - | 22,178 | 8,603 | 61 | 35 | 30,877 |
| Retail | 1,096 | 29,066 | 6,749 | 16 | 3 | 36,930 |
| Services | 12,404 | 27,523 | 13,342 | 5 | 54 | 53,328 |
| Information, technology and communication | 206 | 11,084 | 8,822 | 5 | 1 | 20,118 |
| Manufacturing | 1,024 | 19,072 | 2,901 | 156 | 422 | 23,575 |
| Agriculture | 431 | 6,373 | 1,109 | - | 12 | 7,925 |
| Other | - | 1,019 | 125 | - | - | 1,144 |
| **Total** | **185,662** | **349,667** | **165,235** | **2,519** | **4,270** | **707,353** |

| | Rating grades | | | | | |
|---|---|---|---|---|---|---|
| **As at 31 December 2013** | **10-7** | **6-4** | **3-1** | **0*** | **Unrated** | **Gross carrying amount** |
| Financial institutions | 59,822 | 8,094 | - | - | - | 67,916 |
| Public entities | 8,149 | 1,485 | 261 | - | 19 | 9,914 |
| Individuals | 58,283 | 83,424 | 26,089 | 855 | 4,228 | 172,879 |
| Corporations | | | | | | |
| Fisheries | 11,938 | 88,350 | 21,534 | 778 | - | 122,600 |
| Construction and real estate companies | 67 | 81,600 | 32,591 | 104 | 15 | 114,377 |
| Holding companies | 727 | 26,250 | 16,931 | 10 | 29 | 43,947 |
| Retail | 29 | 25,515 | 5,591 | 264 | 23 | 31,422 |
| Services | 132 | 30,599 | 10,494 | 36 | 137 | 41,398 |
| Information, technology and communication | 4 | 14,773 | 1,453 | - | - | 16,230 |
| Manufacturing | 2,187 | 13,237 | 4,053 | 1,481 | 341 | 21,299 |
| Agriculture | 244 | 5,628 | 1,023 | - | 15 | 6,910 |
| Other | - | 493 | 772 | - | 3,285 | 4,550 |
| **Total** | **141,582** | **379,448** | **120,792** | **3,528** | **8,092** | **653,442** |

* 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.

### 64. 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.

| **As at 31 December 2014** | **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 | - | 1 | 84 | 7 | 6 | 98 |
| Individuals | 2,419 | 7,321 | 3,430 | 1,352 | 976 | 15,498 |
| Corporations | 521 | 3,787 | 3,336 | 696 | 1,079 | 9,419 |
| **Total** | **2,940** | **11,109** | **6,850** | **2,055** | **2,061** | **25,015** |
| **As at 31 December 2013** | | | | | | |
| Public entities | - | 105 | 1 | 24 | 20 | 150 |
| Individuals | 180 | 9,630 | 3,276 | 1,003 | 6,702 | 20,791 |
| Corporations | 1,069 | 11,382 | 3,392 | 977 | 17,113 | 33,933 |
| **Total** | **1,249** | **21,117** | **6,669** | **2,004** | **23,835** | **54,874** |

## 65. Loans and advances by industry sectors

The tables below show credit exposure, allowances and impairment by industry and customer segment.

| | | | | Individually impaired | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | Of which performing | | Of which non-performing* | | |
| At 31 December 2014 | Gross carrying amount | Gross not individually impaired | Collective allowance | Gross carrying amount | Individual allowance | Gross carrying amount | Individual allowance | Carrying amount |
| Financial institutions | 49,789 | 49,789 | - | - | - | - | - | 49,789 |
| Public entities | 13,831 | 13,717 | (25) | 59 | (57) | 56 | (42) | 13,708 |
| Individuals | 254,955 | 228,952 | (2,240) | 7,118 | (3,776) | 18,884 | (10,007) | 238,931 |
| Corporations | | | | | | | | |
| Fisheries | 162,507 | 150,959 | (637) | 8,881 | (4,497) | 2,667 | (1,350) | 156,023 |
| Construction and real estate companies | 119,926 | 109,273 | (1,552) | 6,119 | (2,850) | 4,534 | (2,644) | 112,880 |
| Holding companies | 45,451 | 31,249 | (603) | 13,443 | (1,451) | 758 | (535) | 42,861 |
| Retail | 42,198 | 37,788 | (491) | 2,752 | (1,621) | 1,657 | (968) | 39,117 |
| Services | 59,228 | 56,166 | (1,137) | 929 | (579) | 2,133 | (1,125) | 56,387 |
| Information, technology and communication | 20,454 | 20,219 | (486) | 86 | (61) | 149 | (109) | 19,798 |
| Manufacturing | 30,837 | 24,324 | (433) | 5,276 | (1,015) | 1,238 | (629) | 28,761 |
| Agriculture | 9,269 | 8,786 | (104) | 126 | (122) | 358 | (293) | 8,751 |
| Other | 1,145 | 1,146 | (8) | - | - | - | - | 1,138 |
| **Total** | **809,590** | **732,368** | **(7,716)** | **44,789** | **(16,029)** | **32,434** | **(17,702)** | **768,144** |

| | | | | Individually impaired | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | Of which performing | | Of which non-performing* | | |
| At 31 December 2013 | Gross carrying amount | Gross not individually impaired | Collective allowance | Gross carrying amount | Individual allowance | Gross carrying amount | Individual allowance | Carrying amount |
| Financial institutions | 67,916 | 67,916 | - | - | - | - | - | 67,916 |
| Public entities | 10,149 | 10,065 | (58) | 70 | (63) | 14 | (12) | 10,016 |
| Individuals | 217,719 | 193,669 | (3,114) | 11,866 | (6,341) | 12,184 | (6,779) | 201,486 |
| Corporations | | | | | | | | |
| Fisheries | 155,176 | 130,702 | (782) | 22,454 | (6,745) | 2,020 | (1,348) | 146,300 |
| Construction and real estate companies | 136,224 | 122,365 | (2,191) | 5,925 | (3,704) | 7,934 | (3,098) | 127,231 |
| Holding companies | 59,808 | 45,547 | (738) | 12,641 | (1,836) | 1,620 | (1,420) | 55,814 |
| Retail | 41,666 | 34,081 | (825) | 5,742 | (3,454) | 1,843 | (1,414) | 35,973 |
| Services | 50,375 | 46,620 | (1,013) | 1,502 | (1,082) | 2,253 | (1,663) | 46,616 |
| ITC | 20,096 | 19,847 | (426) | 181 | (150) | 68 | (61) | 19,459 |
| Manufacturing | 26,814 | 25,225 | (355) | 1,148 | (923) | 441 | (198) | 25,340 |
| Agriculture | 8,514 | 7,728 | (101) | 388 | (370) | 398 | (329) | 7,714 |
| Other | 4,871 | 4,550 | (63) | - | - | 320 | (288) | 4,519 |
| **Total** | **799,328** | **708,315** | **(9,666)** | **61,917** | **(24,668)** | **29,095** | **(16,610)** | **748,384** |

*Non-performing past due more than 90 days

### 66. Allowance for impairment on loans and advances to financial institutions and customers and other financial assets

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Individual allowance | Collective allowance | Total | Individual allowance | Collective allowance | Total |
| Balance at the beginning of the year | (41,278) | (9,666) | (50,944) | (28,523) | (15,507) | (44,030) |
| New provisions | (19,209) | - | (19,209) | (16,686) | - | (16,686) |
| Reversals | 16,852 | 1,827 | 18,679 | 1,659 | 5,815 | 7,474 |
| Provisions used to cover write-offs | 9,917 | - | 9,917 | 2,156 | - | 2,156 |
| Translation difference | (13) | 123 | 110 | 116 | 26 | 142 |
| **Balance at the end of the period** | **(33,731)** | **(7,716)** | **(41,447)** | **(41,278)** | **(9,666)** | **(50,944)** |

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Customers | Financials | Total | Customers | Financials | Total |
| New provisions | (19,209) | - | (19,209) | (16,686) | - | (16,686) |
| Write-offs | (14,905) | - | (14,905) | (7,430) | - | (7,430) |
| Provisions used to cover write-offs | 9,917 | - | 9,917 | 2,156 | - | 2,156 |
| Reversals | 18,679 | - | 18,679 | 7,474 | - | 7,474 |
| Recoveries | 3,242 | - | 3,242 | 6,369 | - | 6,369 |
| Translation difference | 110 | - | 110 | 142 | - | 142 |
| Impairment loss for the period | (2,166) | 0 | (2,166) | (7,975) | 0 | (7,975) |
| Impairment of claims reversed | - | 128 | 128 | - | 269 | 269 |
| **Net impairment loss for the period** | **(2,166)** | **128** | **(2,038)** | **(7,975)** | **269** | **(7,706)** |

### 67. 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 2014 the Bank continued its focus and effort in restructuring loans to individuals and companies.

### 68. Large exposures

As at 31 December 2014, six customer groups were rated as large exposures in accordance with FME's Rules on Large Exposures Incurred by Financial Undertakings, No. 625/2013. Customers 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 exposure amount is calculated after taking account of eligible collateral held. No exposure may attain the equivalent of 25% of the capital base. With respect to eligible credit mitigation there are three large exposures as at 31 December 2014 (31 December 2013; two groups of connected counterparties).

| At 31 December 2014 | Number of large exposures | Large exposures |
|---|---|---|
| Large exposures between 10% and 20% of the Group's capital base | 3 | 102,217 |
| **Total** | **3** | **102,217** |
| | | |
| Total large exposure to capital base (400% is the maximum limit) | | 41% |
| | | |
| **At 31 December 2013** | | |
| Large exposures between 10% and 20% of the Group's capital base | 2 | 70,696 |
| **Total** | **2** | **70,696** |
| | | |
| Total large exposure to capital base (400% is the maximum limit) | | 30% |

### 69. Bonds and debt instruments

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

| Carrying amount | 2014 | 2013 |
|---|---|---|
| AAA/AA+/AA/AA- | 66,959 | 112,123 |
| BBB/BBB- | 141,292 | 136,789 |
| Lower than BBB- | 12,825 | 15,157 |
| Unrated | 22,513 | 26,526 |
| **Total** | **243,589** | **290,595** |

## 69. Bonds and debt instruments (continued)

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 2014 | Past due 0 - 90 days | Past due over 90 days | Carrying amount |
|---|---|---|---|
| Holding companies | - | 7,871 | 7,871 |
| Other | - | 150 | 150 |
| **Total** | **0** | **8,021** | **8,021** |
| **At 31 December 2013** | | | |
| Holding companies | - | 9,655 | 9,655 |
| Other | - | 204 | 204 |
| **Total** | **0** | **9,859** | **9,859** |

## 70. Derivative instruments

The following table summarises the Group's exposure in derivative instruments, classified by the Bank into equivalent Standard & Poor's ratings by counterparty:

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Notional | Fair value | | Notional | Fair value | |
| | amount | Assets | Liabilities | amount | Assets | Liabilities |
| A+/A/A- | 18,640 | 35 | 51 | 35,565 | 421 | 62 |
| BBB+ to BBB- | 6,254 | 4 | 252 | 1,573 | 1 | 453 |
| Lower than BBB- | - | - | - | 476 | 1 | - |
| Unrated | 4,430 | 39 | 29 | 14,337 | 231 | 67 |
| **Total** | **29,324** | **78** | **332** | **51,951** | **654** | **582** |

## 71. Offsetting financial assets and financial liabilities

The following table shows reconciliation to the net amounts of financial assets and financial liabilities. Those financial assets and financial liabilities are subject to offsetting, enforceable master netting agreements and similar agreements.

### 31 December 2014

Financial assets subject to offsetting, enforceable master netting arrangement and similar agreements

| | Assets subject to netting agreements | | | Netting not recognised on balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| Types of financial assets | Financial assets | Financial liabilities | Net amount | Financial liabilities | Collateral received | Net financial assets with netting agreements | Financial assets not subject to netting agreements | Net amount on balance sheet |
| Derivatives | 78 | - | 78 | (26) | (35) | 17 | - | 78 |

Financial liabilities subject to offsetting, enforceable master netting arrangement and similar agreement

| | Financial assets subject to netting agreements | | | Netting not recognised on balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| Types of financial liabilites | Financial liabilities | Financial assets | Net amount | Financial assets | Collateral pledged | Net financial assets with netting agreements | Financial assets not subject to netting agreements | Net amount on balance sheet |
| Derivatives | (81) | - | (81) | 26 | 32 | (23) | (252) | (332) |
| Short positions | (5,077) | - | (5,077) | - | 5,077 | - | - | (5,077) |
| **Total** | **(5,158)** | **0** | **(5,158)** | **26** | **5,109** | **(23)** | **(252)** | **(5,409)** |

### 71. Offsetting financial assets and financial liabilities (continued)

#### 31 December 2013

Financial assets subject to offsetting, enforceable master netting arrangement and similar agreement

| | Financial assets subject to netting agreements | | | Netting not recognised on balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| Types of financial assets | Financial assets | Financial liabilities | Net Amount | Financial liabilities | Collateral received | Net financial assets with netting agreements | Financial assets not subject to netting agreements | Net amount on balance sheet |
| Derivatives | 654 | - | 654 | (42) | (31) | 581 | - | 654 |

Financial liabilities subject to offsetting, enforceable master netting arrangement and similar agreement

| | Financial assets subject to netting agreements | | | Netting not recognised on balance sheet | | | | |
|---|---|---|---|---|---|---|---|---|
| Types of financial liabilities | Financial liabilities | Financial assets | Net Amount | Financial assets | Collateral pledged | Net financial assets with netting agreements | Financial assets not subject to netting agreements | Net amount on balance sheet |
| Derivatives | (129) | - | (129) | 42 | 43 | (44) | (453) | (583) |
| Short positions | (6,988) | - | (6,988) | - | 6,987 | - | - | (6,988) |
| **Total** | **(7,117)** | **0** | **(7,117)** | **42** | **7,030** | **(44)** | **(453)** | **(7,571)** |

## Liquidity risk

### 72. 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.

### 73. Liquidity risk management

A liquidity management policy for the Bank and its subsidiaries is in place. 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. Furthermore, the liquidity management policy is to describe the manner in which the Bank identifies, evaluates, measures, monitors, manages and reports its liquidity. 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 where the main metric for measuring liquidity risk is the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The objective of the LCR is to promote short-term resilience by ensuring that the Bank has sufficient high-quality liquid assets to survive a significant stress scenario lasting 30 calendar days. NSFR has a time horizon of longer term and its objective is to capture structural issues in the balance sheet with the aim to provide a sustainable maturity structure of assets and liabilities and to limit overreliance on short-term wholesale funding.

In the year 2014 the Group followed liquidity rules set by the Central Bank of Iceland No. 1031/2014 as well as following guidelines No. 2/2010 from the Icelandic Financial Supervisory Authority in Iceland (FME) on best practice for managing liquidity in banking organisation. The liquidity rules issued by the Central Bank of Iceland require the Group to maintain a LCR minimum of 70% total and 100% for foreign currencies at the end of year 2014. The LCR total minimum requirement will increase by 10 percentage points every year until it reaches 100% in the year 2017. The Central Bank of Iceland issued new rules on commercial banks' foreign currency funding ratios as of 1 December 2014 which set requirements for a minimum of 80% NSFR in foreign currencies at year-end 2014 and in 2015. The minimum NSFR requirements in foreign currencies will then increase by 10 percentage points every year, reaching 100% in 2017. The Group submits monthly reports on its liquidity position to the Central Bank of Iceland and the FME.

The Group has implemented a risk appetite where these rules and guidelines as well as inner requirements within the Bank set benchmarks 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 Bank's internal audit assesses whether the liquidity management process is designed properly and operating effectively.

The Group monitors intraday liquidity risk, short-term 30 day liquidity risk, medium and longer-term liquidity risk and risk arising from mismatches of longer term assets and liabilities. The Group has neither defaulted on any principal or interest nor breached any covenants in respect of liabilities in the years 2014 and 2013.

### 73. Liquidity risk management (continued)

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 indicator of short-term liquidity risk is measured by the liquidity coverage ratio (LCR) which shows the ratio of high quality liquid assets to expected total net cash outflows over the next 30 days under a specified stress scenario. High quality liquid assets are comprised of cash at hand, balances with Central Bank, assets eligible for repo transactions with Central Bank and zero percent risk-weighted foreign government bonds. The Group measures the NSFR as another key indicator for longer-term liquidity risk. The following table shows values of the LCR at year-end 2014 and 2013 and the values of NSFR for foreign currencies as at 31 December 2014. Comparison at year-end 2013 is not inplace since the rules regarding NSFR did not take place until year-end 2014:

| | Liquidity coverage ratio total | Liquidity coverage ratio FX | Net stable funding ratio FX |
|---|---|---|---|
| As at 31 December 2014 | 131% | 614% | 134% |
| As at 31 December 2013 | 102% | 208% | |

Another 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 the Central Bank, loans to financial institutions (maturity within seven days), assets eligible for repo transactions with the Central Bank and zero percent risk-weighted foreign 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 the Central Bank and loans to financial institutions (maturity within seven days). The following table shows various values of the core liquidity ratio and cash ratio in the year 2014 and 2013:

| | Core liquidity ratio | | Cash ratio | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Year-end | 39% | 50% | 10% | 13% |
| Maximum | 53% | 53% | 21% | 22% |
| Minimum | 38% | 41% | 9% | 10% |
| Average | 49% | 47% | 15% | 16% |

### 74. 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 methodology in the liquidity rules set by the Central Bank of Iceland 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:

| | | 2014 | | 2013 | |
|---|---|---|---|---|---|
| **Groups** | **Criteria** | **% of total** | **Amount** | **% of total** | **Amount** |
| Individuals | Individuals | 38.4% | 232,566 | 36.1% | 225,150 |
| Small and medium size corporates | Businesses that have less than EUR 1 million in deposits | 9.5% | 57,720 | 8.1% | 50,616 |
| Large corporates | Businesses that have greater than or equal to EUR 1 million in deposits | 13.2% | 79,997 | 11.0% | 68,384 |
| Government, municipalities and Central Bank | Government, municipalities and Central Bank | 4.8% | 29,090 | 4.5% | 27,961 |
| Financial institutions, securities firms and insurance companies | Financial institutions, securities firms and insurance companies | 15.7% | 94,936 | 17.7% | 110,524 |
| Financial institutions, in resolution process | Financial institutions in resolution process | 17.8% | 107,678 | 22.1% | 137,583 |
| Other foreign counterparties | Businesses with residency outside of Iceland | 0.5% | 3,275 | 0.6% | 3,662 |
| **Total** | | **100%** | **605,262** | **100%** | **623,880** |

The table above shows the deposit base split between different groups at year-end 2014 and 2013 from the estimated most sticky group to the least sticky.

## 75. Maturity analysis of financial assets and liabilities

The following table shows a maturity analysis of the Group's financial instruments as at 31 December 2014:

| Non-derivative financial assets | 0-1 months | 1-3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 10,160 | - | - | - | - | - | 10,160 | 10,160 |
| Bonds and debt instruments | 25,074 | 41,440 | 9,291 | 180,353 | 26,538 | - | 282,696 | 243,589 |
| Equities and equity instruments | - | - | - | - | - | 29,433 | 29,433 | 29,433 |
| Loans and advances to financial institutions | 38,916 | 2,281 | - | 6,635 | 1,961 | - | 49,793 | 49,789 |
| Loans and advances to customers | 64,372 | 50,549 | 123,871 | 328,812 | 493,539 | - | 1,061,143 | 718,355 |
| Other financial assets | 19,178 | - | - | 555 | - | - | 19,733 | 19,733 |
| **Total** | **157,700** | **94,270** | **133,162** | **516,355** | **522,038** | **29,433** | **1,452,958** | **1,071,059** |
| | | | | | | | | |
| **Derivative financial assets** | | | | | | | | |
| **Gross settled derivatives** | | | | | | | | 36 |
| Inflow | 11,193 | 4,033 | - | - | - | - | 15,226 | |
| Outflow | (11,161) | (4,031) | - | - | - | - | (15,192) | |
| Total | **32** | **2** | **0** | **0** | **0** | **0** | **34** | **36** |
| **Net settled derivatives** | 42 | - | - | - | - | - | 42 | 42 |
| **Total** | **74** | **2** | **0** | **0** | **0** | **0** | **76** | **78** |
| | | | | | | | | |
| **Non-derivative financial liabilities** | | | | | | | | |
| Due to financial institutions and Central Bank | (53,234) | (616) | - | - | - | - | (53,850) | (53,827) |
| Deposits from customers | (395,492) | (84,769) | (52,623) | (18,446) | (3,783) | - | (555,113) | (551,435) |
| Short positions | (5,077) | - | - | - | - | - | (5,077) | (5,077) |
| Secured bonds | (543) | - | (5,195) | (101,755) | (147,875) | - | (255,368) | (207,028) |
| Other financial liabilities | (7,509) | - | - | - | - | - | (7,509) | (7,509) |
| **Total** | **(461,855)** | **(85,385)** | **(57,818)** | **(120,201)** | **(151,658)** | **0** | **(876,917)** | **(824,876)** |
| | | | | | | | | |
| **Off-balance sheet items** | | | | | | | | |
| Financial guarantees and underwriting commitments | (703) | (1,029) | (3,636) | (7,523) | (7,609) | - | (20,500) | |
| Undrawn loan commitments | (70,117) | - | - | - | - | - | (70,117) | |
| Undrawn overdraft/credit card commitments | (52,798) | - | - | - | - | - | (52,798) | |
| **Total** | **(123,618)** | **(1,029)** | **(3,636)** | **(7,523)** | **(7,609)** | **0** | **(143,415)** | |
| | | | | | | | | |
| **Total non-derivative financial liabilities and off-balance sheet** | **(585,473)** | **(86,414)** | **(61,454)** | **(127,724)** | **(159,267)** | **0** | **(1,020,332)** | **(824,876)** |
| | | | | | | | | |
| **Derivative financial liabilities** | | | | | | | | |
| **Gross settled derivatives** | | | | | | | | (323) |
| Inflow | 5,572 | 3,201 | 277 | 1,060 | - | - | 10,110 | |
| Outflow | (5,597) | (3,224) | (346) | (1,212) | - | - | (10,379) | |
| Total | **(25)** | **(23)** | **(69)** | **(152)** | **0** | **0** | **(269)** | **(323)** |
| **Net settled derivatives** | (9) | - | - | - | - | - | (9) | (9) |
| **Total** | **(34)** | **(23)** | **(69)** | **(152)** | **0** | **0** | **(278)** | **(332)** |
| | | | | | | | | |
| **Net liquidity position** | **(427,733)** | **7,835** | **71,639** | **388,479** | **362,771** | **29,433** | **432,424** | **245,929** |

## 75. 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 2013:

| Non-derivative financial assets | 0-1 months | 1-3 months | 3-12 months | 1-5 years | Over 5 years | No maturity* | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 21,520 | - | - | - | - | - | 21,520 | 21,520 |
| Bonds and debt instruments | 36,352 | 56,348 | 30,132 | 186,716 | 49,983 | - | 359,532 | 290,595 |
| Equities and equity instruments | - | - | - | - | - | 36,275 | 36,275 | 36,275 |
| Loans and advances to financial institutions | 59,714 | - | 6,394 | 1,811 | - | - | 67,919 | 67,916 |
| Loans and advances to customers | 48,339 | 38,982 | 108,622 | 416,221 | 638,547 | - | 1,250,711 | 680,468 |
| Other financial assets | 5,811 | - | - | 555 | - | - | 6,366 | 6,366 |
| **Total** | **171,736** | **95,330** | **145,149** | **605,303** | **688,531** | **36,275** | **1,742,323** | **1,103,141** |
| **Derivative financial assets** | | | | | | | | |
| **Gross settled derivatives** | | | | | | | | 637 |
| Inflow | 13,645 | 15,884 | 1,361 | - | - | - | 30,890 | |
| Outflow | (13,395) | (15,523) | (1,344) | - | - | - | (30,262) | |
| Total | **250** | **361** | **17** | **0** | **0** | | **628** | **637** |
| **Net settled derivatives** | 17 | - | - | - | - | - | 17 | 17 |
| **Total** | **267** | **361** | **17** | **0** | **0** | **0** | **645** | **654** |
| **Non-derivative financial liabilities** | | | | | | | | |
| Due to financial institutions and Central Bank | (167,128) | (91) | - | - | - | - | (167,219) | (167,218) |
| Deposits from customers | (345,206) | (49,236) | (41,335) | (23,472) | (4,493) | - | (463,743) | (456,662) |
| Short positions | (6,988) | - | - | - | - | - | (6,988) | (6,988) |
| Secured bonds | (4,788) | - | (16,183) | (242,047) | - | - | (263,017) | (239,642) |
| Other financial liabilities | (12,320) | - | - | - | - | - | (12,320) | (12,320) |
| **Total** | **(536,430)** | **(49,327)** | **(57,518)** | **(265,519)** | **(4,493)** | **0** | **(913,287)** | **(882,830)** |
| **Off-balance sheet items** | | | | | | | | |
| Financial guarantees and underwriting commitments | (472) | (877) | (3,802) | (1,141) | (8,072) | - | (14,363) | |
| Undrawn loan commitments | (64,569) | - | - | - | - | - | (64,568) | |
| Undrawn overdraft/credit card commitments | (50,507) | - | - | - | - | - | (50,507) | |
| **Total** | **(115,548)** | **(877)** | **(3,802)** | **(1,141)** | **(8,072)** | **0** | **(129,438)** | **0** |
| **Total non-derivative financial liabilities and off-balance sheet** | **(651,979)** | **(50,204)** | **(61,320)** | **(266,660)** | **(12,565)** | **0** | **(1,042,727)** | **(882,830)** |
| **Derivative financial liabilities** | | | | | | | | |
| **Gross settled derivatives** | | | | | | | | (521) |
| Inflow | 9,317 | 2,560 | 796 | 1,046 | - | - | 13,719 | |
| Outflow | (9,373) | (2,574) | (1,136) | (1,116) | - | - | (14,200) | |
| Total | **(56)** | **(14)** | **(340)** | **(70)** | **0** | **0** | **(480)** | **(521)** |
| **Net settled derivatives** | (62) | - | - | - | - | - | (62) | (62) |
| **Total** | **(118)** | **(14)** | **(340)** | **(70)** | **0** | **0** | **(542)** | **(583)** |
| **Net liquidity position** | **(480,093)** | **45,473** | **83,506** | **338,573** | **675,966** | **36,275** | **699,701** | **220,382** |

* Financial assets and liabilities with no maturity were reported in this table for the first time in the year 2013. This time span is for informative purposes only and does not have any effect on amounts reported in other time spans within the table.

### 75. Maturity analysis of financial assets and liabilities (continued)

The tables above only take into account the contractual maturity of the Group's 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 Group's liquidity position can withstand 39% outflow of deposits (see Note 73). Further information on the Group's liquidity management can also be found in the aforementioned note.

The amounts in the maturity analyses as at year-end 2014 and 2013 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 the time span of 1-5 years.

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 relevant interest rates and exchange rates prevailing at the reporting date. For inflation-linked assets and liabilities the Group uses a constant yearly inflation according to the 12 month inflation at the reporting date. 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 span. Where the Group is committed to have amounts available in installments, each installment is allocated to the earliest period in which the Group might be required to pay. Thus undrawn loan commitments are included in the time span 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

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 74 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 2014 and 2013. When managing liquidity risk the Group regards spot deals as non-derivative assets or liabilities.

### 76. 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 2014:

| Non-derivative financial assets | 0-1 months | 1-3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Total in foreign currencies | 100,974 | 64,640 | 40,261 | 153,348 | 7,634 | 220 | 367,077 | 345,425 |
| ISK | 56,726 | 29,630 | 92,901 | 363,007 | 514,404 | 29,213 | 1,085,881 | 725,634 |
| **Total** | **157,700** | **94,270** | **133,162** | **516,355** | **522,038** | **29,433** | **1,452,958** | **1,071,059** |
| **Derivative financial assets** | | | | | | | | |
| Total in foreign currencies | (432) | 2 | - | - | - | - | (430) | 36 |
| ISK | 506 | - | - | - | - | - | 506 | 42 |
| **Total** | **74** | **2** | **0** | **0** | **0** | **0** | **76** | **78** |
| **Non-derivative financial liabilities** | | | | | | | | |
| Total in foreign currencies | (108,504) | (10,283) | (12,231) | (93,182) | (147,875) | - | (372,075) | (325,290) |
| ISK | (353,351) | (75,102) | (45,587) | (27,019) | (3,783) | - | (504,842) | (499,586) |
| **Total** | **(461,855)** | **(85,385)** | **(57,818)** | **(120,201)** | **(151,658)** | **0** | **(876,917)** | **(824,876)** |
| **Off-balance sheet items** | | | | | | | | |
| Total in foreign currencies | (20,869) | (680) | (1,538) | (6,993) | (318) | - | (30,398) | |
| ISK | (102,749) | (349) | (2,098) | (530) | (7,291) | - | (113,017) | |
| **Total** | **(123,618)** | **(1,029)** | **(3,636)** | **(7,523)** | **(7,609)** | **0** | **(143,415)** | |
| **Derivative financial liabilities** | | | | | | | | |
| Total in foreign currencies | 129 | (23) | 108 | 215 | - | - | 429 | (323) |
| ISK | (163) | - | (177) | (367) | - | - | (707) | (9) |
| **Total** | **(34)** | **(23)** | **(69)** | **(152)** | **0** | **0** | **(278)** | **(332)** |
| **Net liquidity position in foreign currencies** | **(28,702)** | **53,656** | **26,600** | **53,388** | **(140,559)** | **220** | **(35,397)** | **19,848** |
| **Net liquidity position in ISK** | **(399,031)** | **(45,821)** | **45,039** | **335,091** | **503,330** | **29,213** | **467,821** | **226,081** |
| **Net liquidity position** | **(427,733)** | **7,835** | **71,639** | **388,479** | **362,771** | **29,433** | **432,424** | **245,929** |

**76. 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 2013:

| Non-derivative financial assets | 0-1 months | 1-3 months | 3-12 months | 1-5 years | Over 5 years | No maturity* | Total | Carrying amount |
|---|---|---|---|---|---|---|---|---|
| Total in foreign currencies | 104,379 | 65,680 | 50,563 | 169,443 | 14,580 | 19,061 | 423,707 | 399,766 |
| ISK | 67,357 | 29,650 | 94,585 | 435,861 | 673,950 | 17,213 | 1,318,617 | 703,375 |
| **Total** | **171,736** | **95,330** | **145,149** | **605,303** | **688,531** | **36,275** | **1,742,324** | **1,103,141** |
| **Derivative financial assets** | | | | | | | | |
| Total in foreign currencies | (1,273) | 31 | (148) | - | - | - | (1,390) | 637 |
| ISK | 1,541 | 330 | 165 | - | - | - | 2,035 | 17 |
| **Total** | **267** | **361** | **17** | **0** | **0** | **0** | **645** | **654** |
| **Non-derivative financial liabilities** | | | | | | | | |
| Total in foreign currencies | (147,609) | (1,108) | (19,121) | (239,879) | - | - | (407,716) | (384,690) |
| ISK | (388,822) | (48,219) | (38,397) | (25,640) | (4,493) | - | (505,571) | (498,140) |
| **Total** | **(536,430)** | **(49,327)** | **(57,518)** | **(265,519)** | **(4,493)** | **0** | **(913,287)** | **(882,830)** |
| **Off-balance sheet items** | | | | | | | | |
| Total in foreign currencies | (27,072) | (501) | (2,122) | (693) | (295) | - | (30,683) | |
| ISK | (88,475) | (376) | (1,680) | (448) | (7,777) | - | (98,755) | |
| **Total** | **(115,548)** | **(877)** | **(3,802)** | **(1,141)** | **(8,072)** | **0** | **(129,438)** | **0** |
| **Derivative financial liabilities** | | | | | | | | |
| Total in foreign currencies | 341 | (14) | (341) | 686 | - | - | 672 | (521) |
| ISK | (458) | - | - | (756) | - | - | (1,214) | (62) |
| **Total** | **(118)** | **(14)** | **(340)** | **(70)** | **0** | **0** | **(542)** | **(583)** |
| **Net liquidity position in foreign currencies** | **(71,234)** | **64,088** | **28,831** | **(70,443)** | **14,285** | **19,061** | **(15,410)** | **15,192** |
| **Net liquidity position in ISK** | **(408,857)** | **(18,615)** | **54,673** | **409,017** | **661,680** | **17,213** | **715,112** | **205,190** |
| **Net liquidity position** | **(480,093)** | **45,473** | **83,506** | **338,573** | **675,966** | **36,275** | **699,701** | **220,382** |

* Financial assets and liabilities with no maturity are reported in this table for the first time in the year 2013. This time span is for informative purposes only and does not have any effect on amounts reported in other time spans within the table.

The amounts in the maturity analysis as at 31 December 2014 and 31 December 2013 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 75.

## 77. Encumbered assets

In October 2010, the Bank and LBI hf. signed a pledge agreement according to which the Bank commits itself to pledge certain pools of loans to customers as collateral for the secured foreign currency bonds issued to LBI hf. Additional pledges of collateral were made to secure the increased issue of the secured bonds to LBI hf. in April 2013 and the 2013 and 2014 issues of covered bonds. The minimum coverage ratio requirement for the secured bonds issued to LBI hf. has been reduced from 124.7% to 115% under the agreement between the Bank and the Winding-up Board of LBI hf. from 12 June 2014 on extension of the repayment schedule of the secured bonds and amended and restated pledge agreement for these bonds from 4 December 2014. The minimum coverage ratio requirement for the covered bonds is 120%. Pledged assets added to the pledged pool must comply with certain eligibility criteria.

| | Collateral pledged against | | | | |
|---|---|---|---|---|---|
| **At 31 December 2014** | **Covered bonds** | **Issued bonds to LBI hf.** | **Other*** | **Un-encumbered** | **Total** |
| Cash and balances with Central Bank | 1 | - | - | 10,159 | 10,160 |
| Bonds and debt instruments | - | - | 12,771 | 230,818 | 243,589 |
| Equities and equity instruments | - | - | - | 29,433 | 29,433 |
| Derivative instruments | - | - | - | 78 | 78 |
| Loans and advances to financial institutions | - | - | 4,953 | 44,836 | 49,789 |
| Loans and advances to customers | 9,537 | 234,283 | - | 474,535 | 718,355 |
| Investments in equity-accounted associates | - | - | - | 777 | 777 |
| Property and equipment | - | - | - | 5,691 | 5,691 |
| Intangible assets | - | - | - | 1,225 | 1,225 |
| Deferred tax assets | | - | - | 83 | 83 |
| Other assets | - | - | - | 20,978 | 20,978 |
| Assets classified as held for sale | - | - | - | 18,212 | 18,212 |
| **Total** | **9,538** | **234,283** | **17,724** | **836,825** | **1,098,370** |

| | Collateral pledged against | | | | |
|---|---|---|---|---|---|
| **At 31 December 2013** | **Covered bonds** | **Issued bonds to LBI hf.** | **Other*** | **Un-encumbered** | **Total** |
| Cash and balances with Central Bank | 61 | - | - | 21,459 | 21,520 |
| Bonds and debt instruments | - | 11,603 | 15,717 | 263,275 | 290,595 |
| Equities and equity instruments | - | - | - | 36,275 | 36,275 |
| Derivative instruments | - | - | - | 654 | 654 |
| Loans and advances to financial institutions | - | - | 4,608 | 63,308 | 67,916 |
| Loans and advances to customers | 2,400 | 302,159 | - | 375,909 | 680,468 |
| Investments in equity-accounted associates | - | - | - | 14,224 | 14,224 |
| Property and equipment | - | - | - | 5,440 | 5,440 |
| Intangible assets | - | - | - | 585 | 585 |
| Other assets | - | - | - | 8,816 | 8,816 |
| Assets classified as held for sale | - | - | - | 25,023 | 25,023 |
| **Total** | **2,461** | **313,762** | **20,325** | **814,968** | **1,151,516** |

*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.

## Market risk

### 78. 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 is defined as equity price risk and inflation risk, each of which is disclosed in the following notes.

### 79. Market risk management

The Group separates its exposure to market risk into trading and non-trading portfolios, managing each separately. Trading portfolios include positions arising from market-making, hedges for derivative sales and proprietary position-taking. Non-trading portfolios include positions arising from the Group's retail and commercial banking operations and proprietary position-taking as part of asset and liability management within Treasury. Treasury is also responsible for daily liquidity management, 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.

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 a comprehensive risk report twice a year to the Board of Directors. The Group's market risk is thereby measured and monitored on a daily basis, and Market Risk monitors the limits set in the Group's risk appetite and submits these and other market risk measurements to the Risk & 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.

The Group uses risk-weighted assets (RWA) as a common denominator for measuring risk across different asset classes, including those assets subject to market risk. Risk-weighted assets are determined by applying specific risk weights to the Group's assets, following methodology developed by the Basel Committee on Banking Supervision. The following table summarises the Group's exposure to market risk as at 31 December 2014 and 2013:

| | 2014 | 2013 |
|---|---|---|
| **Market risk factor** | % of RWA | % of RWA |
| Equity price risk | 4.7% | 5.8% |
| Interest rate risk | 2.6% | 3.3% |
| Foreign exchange risk | 2.5% | 2.2% |
| **Total** | **9.9%** | **11.3%** |

The currency risk in the Group's trading portfolios is disclosed together with that in its non-trading portfolios in Notes 85-86, together with the related sensitivity analysis.

### 80. Equity price risk

Equity price risk is the risk of equity value fluctuations due to open positions in equity-based instruments.

The Group's main equity portfolios consist of a trading portfolio, strictly focused on listed equites in ISK as part of market making and a proprietary portfolio containing both listed and unlisted equities, as part of asset and liability management. Furthermore, the Bank has a hedge portfolio for derivative sales, containing listed equities in ISK. Further details can be seen in Note 19 and Note 86.

### 81. 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.

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 mismatches 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.

## 81. Interest rate risk (continued)

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 17). The amounts presented are categorised by the earlier of either the contractual repricing or the maturity date.

| At 31 December 2014 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 10,160 | - | - | - | 10,160 |
| Bonds and debt instruments | 223,686 | 4,103 | 2,000 | 13,800 | 243,589 |
| Derivative instruments | 78 | - | - | - | 78 |
| Loans and advances to financial institutions | 43,154 | 6,635 | - | - | 49,789 |
| Loans and advances to customers | 512,873 | 96,206 | 68,537 | 40,739 | 718,355 |
| Other financial assets | 19,178 | - | 555 | - | 19,733 |
| **Total** | **809,129** | **106,944** | **71,092** | **54,539** | **1,041,704** |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | (53,827) | - | - | - | (53,827) |
| Deposits from customers | (529,221) | (20,703) | (1,511) | - | (551,435) |
| Derivative instruments and short positions | (332) | (3,221) | (178) | (1,678) | (5,409) |
| Secured bonds | (199,558) | - | (7,470) | - | (207,028) |
| Other financial liabilities | (7,509) | - | - | - | (7,509) |
| **Total** | **(790,447)** | **(23,924)** | **(9,159)** | **(1,678)** | **(825,208)** |
| | | | | | |
| Net on-balance sheet position | 18,682 | 83,020 | 61,933 | 52,861 | 216,495 |
| Net off-balance sheet position | 430 | (140) | (290) | 0 | |
| | | | | | |
| **Total interest repricing gap** | **19,112** | **82,880** | **61,643** | **52,861** | |

| At 31 December 2013 | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and balances with Central Bank | 21,520 | - | - | - | 21,520 |
| Bonds and debt instruments | 247,179 | 24,117 | 1,856 | 17,443 | 290,595 |
| Derivative instruments | 654 | - | - | - | 654 |
| Loans and advances to financial institutions | 61,522 | 6,394 | - | - | 67,916 |
| Loans and advances to customers | 489,925 | 76,299 | 71,237 | 43,007 | 680,468 |
| Other financial assets | 5,811 | - | 555 | - | 6,366 |
| **Total** | **826,611** | **106,810** | **73,648** | **60,450** | **1,067,519** |
| | | | | | |
| **Financial liabilities** | | | | | |
| Due to financial institutions and Central Bank | (167,218) | - | - | - | (167,218) |
| Deposits from customers | (446,451) | (9,401) | (810) | - | (456,662) |
| Derivative instruments and short positions | (4,594) | - | (2,494) | (483) | (7,571) |
| Secured bonds | (237,717) | - | (1,925) | - | (239,642) |
| Other financial liabilities | (12,320) | - | - | - | (12,320) |
| **Total** | **(868,300)** | **(9,401)** | **(5,229)** | **(483)** | **(883,413)** |
| | | | | | |
| Net on-balance sheet position | (41,689) | 97,409 | 68,419 | 59,967 | 184,106 |
| Net off-balance sheet position | (538) | 126 | 412 | 0 | |
| | | | | | |
| **Total interest repricing gap** | **(42,227)** | **97,535** | **68,831** | **59,967** | |

## 82. 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 rate curves through changes in the fair value of its bond trading portfolios at year-end 2014 and 2013 and cash flows for the next 12 months, assuming a constant position.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| **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 | (144) | 129 | 100 | (190) | 182 |
| ISK, CPI indexed | 50 | 1,185 | (1,067) | 50 | 1,361 | (1,227) |
| USD | 20 | 89 | (89) | 20 | 3 | (3) |
| **Total** | | **1,130** | **(1,027)** | | **1,174** | **(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.

The following table shows how the Group's profit before tax would have been affected by a change of +/-5% 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 17):

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **Increase** | **Decrease** | **Increase** | **Decrease** |
| ISK | 373 | (373) | 280 | (280) |
| Other | 4 | (4) | 131 | (131) |
| **Total** | **377** | **(377)** | **411** | **(411)** |

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 (loss) before tax would have been affected by a change of +/-5% in the key unobservable inputs used in valuation of equity and equity instruments held by the Group at year-end which are classified into Level 3 (as defined in Note 17):

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **Increase** | **Decrease** | **Increase** | **Decrease** |
| ISK | 1,300 | (1,163) | 377 | (373) |
| Other | 7 | (7) | 822 | (822) |
| **Total** | **1,307** | **(1,170)** | **1,199** | **(1,195)** |

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.

## 83. Sensitivity analysis for non-trading portfolios

The management of interest rate risk 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 banking book by measuring the impact on profit of shifting the interest rate curves for every currency. The Bank is now applying more severe interest rate shocks to the relevant interest rate curves. The magnitudes of the shifts are based on guidelines from the European Banking Authority (EBA) and the Financial Supervisory Authority in Iceland.

The following table shows how the Group's profit before tax would have been affected by a parallel shift in all interest rate curves, with all other variables held constant, as related to risk exposure at year-end 2014 and 2013 and cash flows for the next 12 months, assuming a constant position.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| 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 | 400 | 577 | (577) | 400 | 601 | (601) |
| ISK, CPI indexed | 240 | 325 | (325) | 240 | 274 | (274) |
| EUR | 200 | 243 | (243) | 200 | 320 | (320) |
| Other | 200 | 302 | (302) | 200 | 366 | (366) |
| **Total** | | **1,447** | **(1,447)** | | **1,561** | **(1,561)** |

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.

## 84. 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-linked financial instruments may fluctuate due to changes in the Icelandic CPI. The Group has a considerable imbalance in its CPI-linked assets and liabilities. To mitigate this imbalance the Bank offers non-CPI-linked loans and CPI-linked deposits as well as CPI-linked interest rate swaps.

CPI indexation risk is managed centrally within the Group by Treasury, and is monitored by Market Risk. The following table summarizes the Group's CPI imbalance, calculated as the difference between CPI-linked financial assets and liabilities, as at year-end 2014 and 2013.

| Carrying amount | 2014 | 2013 |
|---|---|---|
| **Assets** | | |
| Bonds and debt instruments | 16,680 | 18,688 |
| Loans and advances to customers | 239,605 | 249,681 |
| **Total** | **256,285** | **268,369** |
| | | |
| **Liabilities** | | |
| Short positions | (756) | (483) |
| Deposits from customers | (97,378) | (102,555) |
| **Total** | **(98,134)** | **(103,038)** |
| | | |
| Total on-balance sheet position | 158,152 | 165,331 |
| Total off-balance sheet position | (572) | (796) |
| | | |
| **Total CPI indexation balance** | **157,580** | **164,535** |

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 the CPI applied to the inflation risk exposures in existence at 31 December 2014, with no change in other variables, would have changed net interest income by ISK 1,582 million (31 December 2013: ISK 1,653 million). The Group'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 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 medium and longer term.

## 85. Currency risk (all portfolios)

The Group follows 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 its 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 2014 was +8,14% of the Group's capital base (31.12.2013: +6,1%). Uncertainty regarding the denomination currencies of the Group's loan portfolio has not been fully resolved in the year 2014. As explained in note 4 (h) and 35 there are few rulings concerning these denomination currencies that the Icelandic courts have not yet passed judgement.

## 86. Concentration of currency risk

The following tables summarise the Group's exposure to currency risk as at year-end 2014 and 2013. 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 as at year-end 2014 and 2013. When managing liquidity risk the Group regards spot deals as non-derivative assets or liabilities .

| As at 31 December 2014 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 513 | 240 | 261 | 10 | 43 | 277 | 1,344 |
| Bonds and debt instruments | 12,970 | 30,485 | 44,519 | - | - | - | 87,974 |
| Equities and equity instruments | 146 | - | 2 | - | - | 73 | 221 |
| Derivative instruments | 39 | - | - | - | - | - | 39 |
| Loans and advances to financial institutions | 17,270 | 13,448 | 3,255 | 440 | 175 | 5,695 | 40,283 |
| Loans and advances to customers | 97,232 | 14,308 | 64,190 | 4,265 | 7,350 | 12,037 | 199,382 |
| Other assets | 16,645 | - | 14 | 1 | - | 31 | 16,691 |
| **Total** | **144,815** | **58,481** | **112,241** | **4,716** | **7,568** | **18,113** | **345,934** |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (137) | (155) | (79) | - | (1) | (25) | (397) |
| Deposits from customers | (52,938) | (26,779) | (35,299) | (799) | (1,311) | (6,372) | (123,498) |
| Derivative instruments and short positions | (65) | (1) | (237) | - | - | - | (303) |
| Secured bonds | (94,895) | (30,526) | (74,136) | - | - | - | (199,557) |
| Other liabilities | (762) | (245) | (407) | (7) | (7) | (431) | (1,859) |
| **Total** | **(148,797)** | **(57,706)** | **(110,158)** | **(806)** | **(1,319)** | **(6,828)** | **(325,614)** |
| Net on-balance sheet position | (3,982) | 775 | 2,083 | 3,910 | 6,249 | 11,285 | **20,320** |
| Net off-balance sheet position | 21,259 | (198) | (1,297) | (3,676) | (6,668) | (9,420) | **0** |
| **Net currency position** | **17,277** | **577** | **786** | **234** | **(419)** | **1,865** | **20,320** |

| At 31 December 2013 | EUR | GBP | USD | JPY | CHF | Other | Total |
|---|---|---|---|---|---|---|---|
| **Assets** | | | | | | | |
| Cash and balances with Central Bank | 505 | 228 | 238 | 11 | 38 | 309 | 1,329 |
| Bonds and debt instruments | 44,188 | 41,335 | 48,450 | - | - | - | 133,973 |
| Equities and equity instruments | 16,443 | - | 1 | - | - | 2,617 | 19,061 |
| Derivative instruments | 635 | - | 2 | - | - | - | 637 |
| Loans and advances to financial institutions | 24,055 | 5,173 | 18,902 | 1,495 | 946 | 8,068 | 58,639 |
| Loans and advances to customers | 87,986 | 17,841 | 52,829 | 7,257 | 8,072 | 12,746 | 186,731 |
| Other assets | - | - | 8 | - | - | 25 | 33 |
| **Total** | **173,812** | **64,577** | **120,430** | **8,763** | **9,056** | **23,765** | **400,403** |
| **Liabilities** | | | | | | | |
| Due to financial institutions and Central Bank | (37,579) | (14,418) | (22,251) | - | (137) | (670) | (75,055) |
| Deposits from customers | (29,202) | (4,841) | (24,250) | (407) | (721) | (10,724) | (70,145) |
| Derivative instruments and short positions | (80) | - | (440) | - | - | - | (520) |
| Secured bonds | (119,808) | (45,877) | (72,032) | - | - | - | (237,717) |
| Other liabilities | (775) | (175) | (346) | - | (4) | (491) | (1,791) |
| **Total** | **(187,444)** | **(65,311)** | **(119,319)** | **(407)** | **(862)** | **(11,885)** | **(385,228)** |
| Net on-balance sheet position | (13,632) | (734) | 1,111 | 8,356 | 8,194 | 11,880 | **15,175** |
| Net off-balance sheet position | 29,124 | (95) | 39 | (8,999) | (8,459) | (12,328) | **(718)** |
| **Net currency position** | **15,492** | **(829)** | **1,150** | **(643)** | **(265)** | **(448)** | **14,457** |

### 87. Sensitivity to currency risk

The following table shows how other net operating income would have been affected by a 10% depreciation/appreciation of the 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 86.

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Currency (ISK million)** | **-10%** | **+10%** | **-10%** | **+10%** |
| EUR | 1,728 | (1,728) | 1,549 | (1,549) |
| GBP | 58 | (58) | (83) | 83 |
| USD | 79 | (79) | 115 | (115) |
| JPY | 23 | (23) | (64) | 64 |
| CHF | (42) | 42 | (27) | 27 |
| Other | 187 | (187) | (45) | 45 |
| **Total** | **2,033** | **(2,033)** | **1,445** | **(1,445)** |

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.

### 88. Foreign exchange rates used

The following foreign exchange rates were used by the Group:

| | At 31 Decembe4 2014 | At 31 December 2013 | % Change | Average for 1.1-31.12 2014 | Average for 1.1-31.12 2013 |
|---|---|---|---|---|---|
| EUR/ISK | 154.25 | 158.50 | (2.7%) | 154.67 | 161.54 |
| GBP/ISK | 198.09 | 190.30 | 4.1% | 192.28 | 190.77 |
| USD/ISK | 126.89 | 115.11 | 10.2% | 116.87 | 121.58 |
| JPY/ISK | 1.06 | 1.10 | (3.6%) | 1.10 | 1.26 |
| CHF/ISK | 128.29 | 129.20 | (0.7%) | 127.46 | 131.63 |
| CAD/ISK | 109.58 | 108.24 | 1.2% | 105.76 | 117.94 |
| DKK/ISK | 20.72 | 21.25 | (2.5%) | 20.75 | 21.66 |
| NOK/ISK | 17.10 | 18.95 | (9.8%) | 18.45 | 20.69 |
| SEK/ISK | 16.41 | 17.96 | (8.6%) | 17.02 | 18.67 |

## Operational risk

### 89. 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 managing director of each division is responsible for that division's operational risk, the daily management of operational risk is overseen by the 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 function. 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

### 90. Operations by years

| Operations | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Interest income | 53,735 | 63,224 | 64,661 | 60,831 | 61,060 |
| Interest expense | (25,662) | (28,910) | (29,077) | (28,182) | (36,374) |
| **Net interest income** | **28,073** | **34,314** | **35,584** | **32,649** | **24,685** |
| Net adjustments in valuation of loans and advances | 20,128 | 13,053 | (4,391) | (23,587) | 641 |
| **Net interest income after adjustments in valuation** | **48,201** | **47,367** | **31,193** | **9,062** | **25,326** |
| Fee and commission income | 7,737 | 8,451 | 7,696 | 7,437 | 6,292 |
| Fee and commission expense | (1,901) | (3,160) | (3,248) | (3,014) | (2,710) |
| **Net fee and commission income** | **5,836** | **5,291** | **4,448** | **4,424** | **3,582** |
| **Other operating income** | **9,112** | **12,923** | **13,500** | **17,258** | **21,941** |
| **Net operating income** | **63,149** | **65,581** | **49,141** | **30,743** | **50,849** |
| Salaries and related expenses | (13,567) | (17,304) | (13,176) | (11,990) | (9,331) |
| Administrative expenses | (9,487) | (8,868) | (9,887) | (9,482) | (8,485) |
| Contribution to the Depositors' and Investors' Guarantee Fund | (1,034) | (1,079) | (1,042) | (583) | (680) |
| **Operating expenses** | **(24,088)** | **(27,251)** | **(24,105)** | **(22,055)** | **(18,496)** |
| **Share of profit of associates, net of income tax** | **465** | **2,712** | **2,449** | **1,418** | **291** |
| **Pre-tax profit** | **39,526** | **41,042** | **27,485** | **10,105** | **32,644** |
| Income and bank tax | (9,789) | (12,283) | (4,125) | 597 | (8,182) |
| **Profit from continuing operations** | **29,737** | **28,759** | **23,360** | **10,703** | **24,462** |
| **Profit for the year from discontinued operations, net of income tax** | **0** | **0** | **2,134** | **6,255** | **2,769** |
| **Net profit** | **29,737** | **28,759** | **25,494** | **16,957** | **27,231** |
| **Attributable to:** | | | | | |
| Shareholders of Landsbankinn | 29,737 | 28,750 | 25,439 | 16,973 | 27,228 |
| Minority interests | 0 | 9 | 55 | (16) | 3 |

| Balance Sheet | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Cash and cash balances with Central Bank | 10,160 | 21,520 | 25,898 | 8,823 | 47,777 |
| Bonds and debt instruments | 243,589 | 290,595 | 228,208 | 221,848 | 161,559 |
| Equities and equity instruments | 29,433 | 36,275 | 36,881 | 46,037 | 29,429 |
| Loans and advances to financial institutions | 49,789 | 67,916 | 64,349 | 100,133 | 91,882 |
| Loans and advances to customers | 718,355 | 680,468 | 666,087 | 639,130 | 592,954 |
| Other assets | 28,832 | 29,719 | 38,044 | 65,959 | 28,743 |
| Assets classified as held for sale | 18,212 | 25,023 | 25,320 | 53,552 | 128,789 |
| **Total assets** | **1,098,370** | **1,151,516** | **1,084,787** | **1,135,482** | **1,081,133** |
| Due to financial institutions and Central Bank | 53,827 | 167,218 | 98,718 | 112,876 | 147,478 |
| Deposits from customers | 551,435 | 456,662 | 421,058 | 443,590 | 371,558 |
| Secured bonds | 207,028 | 239,642 | 221,791 | 277,076 | 261,313 |
| Contingent bond | - | - | 87,474 | 60,826 | 26,510 |
| Other liabilities | 32,443 | 42,750 | 29,687 | 31,485 | 27,800 |
| Liabilities associated with assets classified as held for sale | 2,834 | 3,885 | 893 | 9,385 | 61,609 |
| Equity | 250,803 | 241,359 | 225,166 | 200,244 | 184,866 |
| **Total liabilities and equity** | **1,098,370** | **1,151,516** | **1,084,787** | **1,135,482** | **1,081,133** |

| Key ratios | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|
| Return on equity before taxes (Average equity) | 16.7% | 17.6% | 14.0% | 8.1% | 20.8% |
| Return on equity after taxes (Average equity) | 12.5% | 12.4% | 12.0% | 8.4% | 16.0% |
| Capital adequacy ratio | 29.5% | 26.7% | 25.1% | 21.4% | 19.5% |
| Cost-income ratio | 56.0% | 42,9%* | 45.0% | 40.6% | 36.8% |
| Operating expenses as a ratio of average total assets | 2.1% | 2%* | 2.2% | 2.0% | 1.7% |
| Interest spread as a ratio of average total assets | 2.4% | 3.1% | 3.2% | 2.9% | 2.3% |
| Loans / deposits | 130.3% | 149.0% | 158.2% | 144.1% | 159.6% |
| Number of full-time positions at year-end | 1,126 | 1,183 | 1,233 | 1,311 | 1,146 |
| Earnings per share | 1.26 | 1.22 | 1.06 | 0.71 | 1.13 |
| Dividend per share | 0.84 | 0.42 | 0.00 | 0.00 | 0.00 |

*Adjusted for one off items

## 91. Operations by quarters (Unaudited)

| | 2014 | | | | 2013 | | | |
|---|---|---|---|---|---|---|---|---|
| **Operations** | **Q4*** | **Q3** | **Q2** | **Q1** | **Q4*** | **Q3** | **Q2** | **Q1** |
| Interest income | 11,325 | 13,745 | 14,215 | 14,450 | 17,236 | 14,362 | 13,711 | 17,915 |
| Interest expense | (5,549) | (6,688) | (6,830) | (6,595) | (7,259) | (7,022) | (6,593) | (8,036) |
| **Net interest income** | **5,776** | **7,057** | **7,385** | **7,855** | **9,977** | **7,340** | **7,118** | **9,879** |
| Net adjustments to loans and advances acquired at deep discount | 6,467 | 2,531 | 4,301 | 6,711 | 3,178 | 1,317 | 11,352 | 3,593 |
| Gain from foreign currency linkage of loans and advances to customers | 2,156 | - | - | - | - | - | - | - |
| Net impairment loss | (2,522) | 50 | 2,975 | (2,541) | 754 | 234 | (8,035) | (659) |
| Fair value change of contingent bond | - | - | - | - | - | - | - | 1,319 |
| **Net adjustments in valuation** | **6,101** | **2,581** | **7,276** | **4,170** | **3,932** | **1,551** | **3,317** | **4,253** |
| **Net interest income after net adjustments in valuation** | **11,877** | **9,638** | **14,661** | **12,025** | **13,909** | **8,891** | **10,435** | **14,132** |
| Fee and commission income | 2,128 | 1,714 | 1,772 | 2,123 | 1,944 | 1,933 | 2,427 | 2,147 |
| Fee and commission expense | (488) | (439) | (369) | (605) | (764) | (782) | (830) | (784) |
| **Net fee and commission income** | **1,640** | **1,275** | **1,403** | **1,518** | **1,180** | **1,151** | **1,597** | **1,363** |
| Net gain on financial assets designated as at fair value through profit or loss | 2,891 | 1,267 | 1,929 | (787) | 2,365 | 3,188 | 375 | 2,532 |
| Net gain on financial assets and liabilities held for trading | 723 | 571 | 51 | 118 | 401 | 400 | 711 | 580 |
| Net foreign exchange gain (loss) | 107 | 154 | (171) | (23) | (203) | 162 | 16 | 1,172 |
| Other income and (expenses) | 1,193 | (1,104) | 2,401 | (208) | (592) | (165) | 1,708 | 273 |
| **Other net operating income** | **4,914** | **888** | **4,210** | **(900)** | **1,971** | **3,585** | **2,810** | **4,557** |
| **Total operating income** | **18,431** | **11,801** | **20,274** | **12,643** | **17,060** | **13,627** | **14,842** | **20,052** |
| Salaries and related expenses | 3,805 | 3,019 | 3,288 | 3,455 | 3,508 | 2,810 | 3,122 | 7,864 |
| Other operating expenses | 2,635 | 1,740 | 1,965 | 2,205 | 1,923 | 1,884 | 2,109 | 2,134 |
| Depreciation and amortisation | 419 | 171 | 175 | 177 | 176 | 219 | 214 | 209 |
| Contribution to the Depositors' and Investors' Guarantee Fund | 259 | 253 | 255 | 267 | 273 | 268 | 270 | 268 |
| **Total operating expenses** | **7,118** | **5,183** | **5,683** | **6,104** | **5,880** | **5,181** | **5,715** | **10,475** |
| Share of profit of equity-accounted associates, net of income tax | 125 | - | 329 | 11 | 1,585 | - | 866 | 261 |
| **Profit before tax** | **11,438** | **6,618** | **14,920** | **6,550** | **12,764** | **8,446** | **9,993** | **9,838** |
| Income tax | (1,298) | (566) | (3,530) | (1,427) | (3,284) | (1,595) | (2,362) | (1,759) |
| Tax on liabilities of financial institutions | (388) | (945) | (800) | (835) | (2,998) | (100) | (95) | (90) |
| **Profit for the period** | **9,752** | **5,107** | **10,590** | **4,288** | **6,483** | **6,751** | **7,536** | **7,989** |

| **Balance sheet** | **31.12.2014** | **30.9.2014** | **30.6.2014** | **31.3.2014** | **31.12.2013** | **30.9.2013** | **30.6.2013** | **31.3.2013** |
|---|---|---|---|---|---|---|---|---|
| Cash and cash balances with Central Bank | 10,160 | 38,820 | 7,964 | 34,024 | 21,520 | 36,024 | 23,643 | 21,966 |
| Bonds and debt instruments | 243,589 | 293,796 | 297,141 | 284,418 | 290,595 | 288,994 | 278,386 | 248,571 |
| Equities and equity instruments | 29,433 | 40,991 | 42,221 | 36,414 | 36,275 | 33,954 | 34,029 | 32,549 |
| Loans and advances to financial institutions | 49,789 | 68,192 | 67,163 | 63,896 | 67,916 | 70,545 | 70,671 | 56,551 |
| Loans and advances to customers | 718,355 | 719,627 | 699,648 | 681,883 | 680,468 | 671,378 | 665,411 | 663,719 |
| Other assets | 28,832 | 20,222 | 18,342 | 28,615 | 29,719 | 31,325 | 34,219 | 36,396 |
| Assets classified as held for sale | 18,212 | 19,599 | 22,119 | 24,554 | 25,023 | 25,934 | 19,735 | 25,653 |
| **Total assets** | **1,098,370** | **1,201,247** | **1,154,598** | **1,153,804** | **1,151,516** | **1,158,154** | **1,126,094** | **1,085,405** |
| Due to financial institutions and Central Bank | 53,827 | 179,085 | 166,172 | 174,031 | 167,218 | 110,460 | 110,025 | 97,352 |
| Deposits from customers | 551,435 | 497,583 | 473,356 | 468,661 | 456,662 | 465,742 | 448,931 | 433,647 |
| Secured bonds | 207,028 | 233,785 | 231,378 | 234,844 | 239,642 | 298,938 | 297,459 | 206,491 |
| Contingent bond | - | - | - | - | - | - | - | 85,953 |
| Other liabilities | 32,443 | 46,593 | 43,972 | 46,681 | 42,750 | 43,541 | 38,827 | 28,569 |
| Liabilities associated with assets classified as held for sale | 2,834 | 3,214 | 3,826 | 4,195 | 3,885 | 4,761 | 1,022 | 963 |
| Equity | 250,803 | 240,987 | 235,894 | 225,392 | 241,359 | 234,712 | 229,830 | 232,430 |
| **Total liabilities and equity** | **1,098,370** | **1,201,247** | **1,154,598** | **1,153,804** | **1,151,516** | **1,158,154** | **1,126,094** | **1,085,405** |

*The first three quarter results for the years 2014 and 2013 were reviewed by the Bank's independent auditors.