Condensed Consolidated

Interim Financial Statements

Unaudited

Nine months ended 30 September 2014

Íslandsbanki hf.
Kirkjusandur
155 Reykjavík
Reg. no. 491008-0160
Iceland

Contents

Endorsement and Statement by the Board of Directors and the CEO

The unaudited Condensed Consolidated Interim Financial Statements of Íslandsbanki hf. for the period 1 January to 30 September 2014 comprise the Condensed Interim Financial Statements of Íslandsbanki hf. and its subsidiaries, together referred to as “the Bank”.

Accounting convention

The unaudited Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2014 have been prepared and presented on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS) 34 Interim Financial Reporting, as adopted by the European Union.

Profit from the Bank's operations for the period 1 January to 30 September 2014 amounted to ISK 18,190 million, which corresponds to a 13.8% annualised return on equity. Bank equity, according to the Condensed Consolidated Financial Position, amounted to ISK 181,317 million at 30 September 2014. According to the Act on Financial Undertakings no. 161/2002 the official capital ratio of the Bank shall be based on audited or reviewed own fund items. Since the interim financial statements for the third quarter are not audited the official capital ratio is based on reviewed own fund items at 30 June 2014 and risk weighted assets at 30 September 2014. The official capital ratio at 30 September 2014 was 28.9% and the Tier 1 ratio was 25.8%. The capital ratio, based on the reported own fund items at 30 September 2014, was 29.4% and the corresponding Tier 1 ratio was 26.3%. The Board of Directors refers to Note 59 for further understanding of the capital requirements of the Bank. The Bank's total assets amounted to ISK 930,969 million at the end of the period.

The Board of Directors draws special attention to the risks relating to the political and legal environment in Iceland where capital controls are still in place. The Bank has made appropriate provisions to reflect the risks associated with court rulings. The Board also notes that the Bank maintains a strong capital base and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 2 and 40 for the principal risks and uncertainties currently faced by the Bank.

To the best of our knowledge the Condensed Consolidated Interim Financial Statements provide a true and fair view of the Bank's operating profits and its financial position as at 30 September 2014.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's Condensed Consolidated Interim Financial Statements for the period 1 January to 30 September 2014 by means of their signatures.

Reykjavík, 19 November 2014

Board of Directors:
Fridrik Sophusson, Chairman
John E. Mack, Vice-Chairman
Árni Tómasson
Helga Valfells
Marianne Økland
Neil Graeme Brown
Þóranna Jónsdóttir

Chief Executive Officer:
Birna Einarsdóttir

Condensed Consolidated Income Statement for the nine months ended 30 September 2014

	Notes	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Interest income		13,318	13,399	39,579	41,514
Interest expense		(6,250)	(6,034)	(18,943)	(19,631)
Net interest income	11	7,068	7,365	20,636	21,883
Fee and commission income		4,538	4,241	13,240	12,162
Fee and commission expense		(1,689)	(1,779)	(4,719)	(4,578)
Net fee and commission income	12	2,849	2,462	8,521	7,584
Net financial income	13-14	83	315	965	1,865
Net foreign exchange gain (loss)	15	352	409	50	(1,306)
Share of profit of associates net of tax		-	-	27	3
Other net operating income	16	233	314	1,586	1,442
Other net operating income		668	1,038	2,628	2,004
Total operating income		10,585	10,865	31,785	31,471
Administrative expenses	17-18	(5,231)	(5,208)	(16,490)	(17,623)
Contribution to the Depositors' and Investors' Guarantee Fund		(272)	(252)	(790)	(754)
Bank tax		(664)	(76)	(1,879)	(208)
Total operating expenses		(6,167)	(5,536)	(19,159)	(18,585)
Profit before loan impairment charges and net valuation changes		4,418	5,329	12,626	12,886
Loan impairment charges and net valuation changes	19	65	555	5,804	8,405
Profit before tax		4,483	5,884	18,430	21,291
Income tax	20	(1,255)	(1,570)	(4,806)	(5,365)
Profit for the period from continuing operations		3,228	4,314	13,624	15,926
Profit (loss) from discontinued operations, net of income tax		307	(125)	4,566	(529)
Profit for the period		3,535	4,189	18,190	15,397

The notes on pages 8 to 50 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK million

Condensed Consolidated Statement of Comprehensive Income for the nine months ended 30 September 2014

	Notes	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Other comprehensive income					
Foreign currency translation differences for foreign operations		52	(62)	(102)	(231)
Other comprehensive income for the period		52	(62)	(102)	(231)
Total comprehensive income for the period		3,587	4,127	18,088	15,166
Attributable to:					
Equity holders of Íslandsbanki hf.		3,362	4,113	17,826	15,349
Non-controlling interests		173	76	364	48
Profit for the period		3,535	4,189	18,190	15,397
Basic earnings per share	21	0.34	0.41	1.78	1.53
Diluted earnings per share	21	0.34	0.41	1.78	1.53

The notes on pages 8 to 50 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK million

Condensed Consolidated Statement of Financial Position as at 30 September 2014

	Notes	30.9.2014	31.12.2013
Assets			
Cash and balances with Central Bank	7,22	135,138	111,779
Derivatives	7,23	2,165	843
Bonds and debt instruments	7	86,007	75,186
Shares and equity instruments	7	10,884	9,208
Loans to credit institutions	7,24	41,720	44,078
Loans to customers	7,25-26	608,328	554,741
Investments in associates	28	797	1,563
Property and equipment		8,129	8,772
Intangible assets		339	299
Deferred tax assets		694	1,275
Non-current assets and disposal groups held for sale	31	22,897	47,106
Other assets	32	13,871	11,159
Total Assets		930,969	866,009
Liabilities			
Derivative instruments and short positions	7,23	8,118	11,176
Deposits from Central Bank	7,33	35	63
Deposits from credit institutions	7,33	24,370	29,626
Deposits from customers	7,34-35	536,104	489,331
Debt issued and other borrowed funds	7,36	97,714	89,193
Subordinated loans	7	21,089	21,890
Current tax liabilities		14,089	10,806
Deferred tax liabilities		14	20
Non-current liabilities and disposal groups held for sale	31	3,565	9,456
Other liabilities	37	44,554	37,130
Total Liabilities		749,652	698,691
Equity			
Share capital	38	10,000	10,000
Share premium	38	55,000	55,000
Other reserves		2,369	2,471
Retained earnings		112,374	98,548
Total equity attributable to the equity holders of Íslandsbanki hf.		179,743	166,019
Non-controlling interests		1,574	1,299
Total Equity		181,317	167,318
Total Liabilities and Equity		930,969	866,009

The notes on pages 8 to 50 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK million

Condensed Consolidated Statement of Changes in Equity for the nine months ended 30 September 2014

	Attributable to equity holders of Íslandsbanki hf.					Non-controlling interests	Total equity
	Share capital	Share premium	Other reserves	Retained earnings	Total		
Equity at 1.1.2013	10,000	55,000	2,834	78,571	146,405	1,255	147,660
Translation differences for foreign operations			(231)		(231)		(231)
Net expense recognised directly in equity	-	-	(231)	-	(231)	-	(231)
Profit for the period				15,349	15,349	48	15,397
Total comprehensive income for the period	-	-	(231)	15,349	15,118	48	15,166
Changes in non-controlling interests					-	(162)	(162)
Dividends				(3,000)	(3,000)		(3,000)
Equity at 30.9.2013	10,000	55,000	2,603	90,920	158,523	1,141	159,664
Equity at 1.1.2014	10,000	55,000	2,471	98,548	166,019	1,299	167,318
Translation differences for foreign operations			(102)		(102)		(102)
Net expense recognised directly in equity	-	-	(102)		(102)	-	(102)
Profit for the period				17,826	17,826	364	18,190
Total comprehensive income for the period	-	-	(102)	17,826	17,724	364	18,088
Changes in non-controlling interests					-	(89)	(89)
Dividends				(4,000)	(4,000)		(4,000)
Equity at 30.9.2014	10,000	55,000	2,369	112,374	179,743	1,574	181,317

The notes on pages 8 to 50 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK million

Condensed Consolidated Statement of Cash Flows for the nine months ended 30 September 2014

	Notes	2014 1.1-30.9	2013 1.1-30.9
Cash flows from operating activities:			
Profit for the period		18,190	11,208
Adjustments to reconcile profit for the period to cash flows by operating activities:			
Non-cash items included in profit for the period and other adjustments		(1,127)	(1,693)
Changes in operating assets and liabilities		(4,160)	(88)
Income tax paid		(3,065)	(992)
Net cash provided by operating activities		9,838	8,435
Net cash provided by investing activities		761	555
Net cash provided by financing activities		2,948	3,659
Changes in cash and cash equivalents		13,547	12,649
Effects of exchange rate changes on cash and cash equivalents		(142)	(77)
Cash and cash equivalents at the beginning of the period		138,433	112,810
Cash and cash equivalents at the end of the period		151,838	125,382
Reconciliation of cash and cash equivalents:			
Cash on hand	22	2,636	2,251
Cash balances with Central Bank and certificates of deposit	22	123,109	86,712
Bank accounts	24	26,093	36,419
Total cash and cash equivalents		151,838	125,382

Interest received from 1 January to 30 September 2014 amounted to ISK 38,520 million (2013: ISK 34,938 million) and interest paid in the same period 2014 amounted to ISK 21,203 million (2013: ISK 17,559 million). Interest is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 8 to 50 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK million

Notes to the Condensed Consolidated Financial Statements

Notes to the Condensed Consolidated Financial Statements

Accounting policies

General information

1. **The reporting entity**

Íslandsbanki hf. is a limited company incorporated and domiciled in Iceland. The unaudited Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2014 comprise Íslandsbanki hf. (the parent) and its subsidiaries (together referred to as "the Bank").

The Condensed Consolidated Interim Financial Statements were authorised for issue by the Board of Directors of Íslandsbanki hf. on 19 November 2014.

2. **Basis of preparation**

2.1 *Statement of compliance*

The unaudited Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2014 have been prepared and presented on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS) 34 Interim Financial Reporting, as adopted by the European Union.

The Condensed Consolidated Interim Financial Statements do not include all the information required for annual financial statements and should be read in conjunction with the Consolidated Financial Statements of the Bank and the Risk Report for the year ended 31 December 2013, available at the Bank's website www.islandsbanki.is.

2.2 *Basis of measurement*

The unaudited Condensed Consolidated Interim Financial Statements have been prepared on an historical cost basis except for the following items in the statement of financial position: bonds and debt instruments which are measured at fair value, shares and equity instruments which are measured at fair value, derivative financial instruments which are measured at fair value and non-current assets and disposal groups classified as held for sale which are measured at the lower of cost and fair value less cost to sell.

The Condensed Consolidated Interim Financial Statements are presented in Icelandic krona (ISK), which is the functional currency of the Bank, rounded to the nearest million.

2.3 *Significant accounting judgements and estimates*

The preparation of the unaudited Condensed Consolidated 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 recognised in the Condensed Consolidated Financial Statements. The accounting estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

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

2.4 *Going concern*

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has adequate resources to continue its operations for the foreseeable future. Therefore, the Financial Statements are prepared on a going concern basis.

2.5 *Changes in presentation*

The Bank no longer uses the term latent impairment allowance and now presents provision for impairment losses for loans in two categories, individually assessed and collectively assessed. Individually assessed allowance comprises impairment for financial assets that are assessed individually and collectively assessed allowance comprises estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics (see Notes 26 and 27).

2.5 Cont'd

The Bank has added a separate column in Note 47 for unrated loans. These are loans without a formal risk rating or with an expired rating which were previously included in risk class 9. Comparable figures have been adjusted accordingly.

3 **Significant accounting policies**

The same accounting policies, presentation and methods of computation have been followed in these Condensed Consolidated Interim Financial Statements as were applied in the preparation of the Bank's Consolidated Financial Statements for the year ended 31 December 2013, except for the changes related to new or amended accounting standards mentioned here below.

New or amended accounting standards or interpretations that entered into force for the Condensed Consolidated Interim Financial Statement are described below.

IFRS 10 Consolidated Financial Statements
The Bank has adopted IFRS 10 Consolidated Financial Statements which includes a revised definition of control and requires parent companies which are investment entities to measure investments at fair value through profit or loss instead of consolidating those subsidiaries. The application of IFRS 10 did not have a material impact on the Consolidated Financial Statements.

IFRS 12 Disclosure of Interest in Other Entities
IFRS 12 Disclosure of Interest in Other Entities became effective on 1 January 2014. The standard includes disclosure requirements to enable users of the Financial Statements to evaluate (a) the nature of, and risks associated with, the entity's interest in other entities; and (b) the effects of those interest on the entity's financial position, financial performance and cash flows. The Bank will evaluate at year-end whether a more extensive disclosure is necessary to adhere to the standard.

IAS 28 Investments in Associates and Joint Ventures
The Bank has adopted IAS 28 Investments in Associates and Joint Ventures which incorporates requirements for joint ventures into the standard and contains more specific provision with respect to investments in associates and joint ventures which meet the criteria to be classified as held for sale in accordance with IFRS 5 Non-Current Assets Held for Sale and Discontinued Operations. The application of IAS 28 did not have a material impact on the Consolidated Financial Statements.

Other standards and amendments to standards which became effective on 1 January 2014 have no effect on the Consolidated Financial Statements of the Bank.

Business segments

4. A business segment is a distinguishable component of the Bank that is engaged in providing products or services that are subject to risks and rewards that may be different from those of other business segments. Transactions between the business segments are on normal commercial terms and conditions. No single customer generates 10% or more of the combined revenue of the Bank.

The accounting policies for the reportable segments are in line with the Bank's accounting policies. The segment profit presented is the profit reported to the chief operating decision maker (CEO) and the Board of Directors for the purpose of resource allocation and assessment of segment performance.

The Bank is organised into six main business segments based on products and services:

a) Retail Banking operates 18 branches and asset-based financing under the brand name Ergo. The branches provide services to individuals and small and medium-sized enterprises. In addition, the Retail Banking division operates Kreditkort, which is a special credit card branch, call centre and centralised cash centre.

b) Corporate Banking provides lending and tailor-made financial services to larger companies and professional investors. Furthermore, Corporate Banking overseas the Bank's international business in the North Atlantic region where the focus is on the seafood, offshore supply vessel and energy industries.

c) Markets incorporates brokerage services in securities, foreign currencies and derivatives as well as providing money market lending and interbank services. The division further offers an extensive range of corporate finance services. Locally as well as to the international seafood sector.

d) Wealth Management offers a range of wealth and asset management products and services for individuals, corporations and institutional investors. The Wealth Management unit consists of VÍB which offers a broad range of asset management products and services and the fund management company Íslandssjódir.

e) Treasury is responsible for the management of liquidity risk, foreign exchange risk and interest rate risk within regulatory requirements and internal limits established by the Board of Directors. Treasury is also responsible for funding the Bank´s operations and managing an internal pricing framework.

f) Subsidiaries and equity investments include equity investments in the banking book and subsidiaries, the most significant being:
• Midengi, an asset management company managing commercial real estate and businesses which the Bank has acquired through repossessions following loan defaults, debt restructuring and bankruptcies of its customers
• Borgun, a credit card settlement company
• Allianz Ísland hf., an agent for the German insurance company Allianz and its holding company Hringur eignarhaldsfélag ehf.

g) Cost centres comprise Head Office, Human Resources, Risk Management and Credit Control, Legal, Finance, Operations & IT and Relationship Banking.

On the following page is an overview showing the Bank's performance with a breakdown by business segments.

4. Cont'd

1 January to 30 September 2014

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	12,892	3,241	750	562	3,882	(345)	(346)	20,636
Net fee and commission income	3,359	95	1,253	1,424	(61)	2,420	31	8,521
Other net operating income (exps.)	53	386	(251)	(2)	93	2,321	28	2,628
Total operating income	16,304	3,722	1,752	1,984	3,914	4,396	(287)	31,785
Administrative expenses	(4,628)	(360)	(754)	(819)	(225)	(2,422)	(7,282)	(16,490)
Insurance fund	(691)	(14)	(0)	(57)	(28)	(0)	-	(790)
Bank tax	-	-	-	-	(1,879)	-	-	(1,879)
Impairment charges and net valuation changes	3,660	1,508	-	0	34	916	(314)	5,804
Profit (loss) before cost allocation & tax	14,645	4,856	998	1,108	1,816	2,890	(7,883)	18,430
Net segment revenue from external customers	16,664	8,815	2,219	(59)	(1,011)	5,084	73	31,785
Net segment revenue from other segments	(360)	(5,093)	(467)	2,043	4,925	(688)	(360)	0

At 30 September 2014	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Total segment assets	408,720	204,343	21,852	4,113	235,871	92,285	(36,215)	930,969
Total segment liabilities	416,050	9,430	6,507	54,365	237,785	40,925	(15,410)	749,652

1 January to 30 September 2013

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	16,053	3,225	382	608	3,424	(1,405)	(404)	21,883
Net fee and commission income	2,535	127	1,220	1,322	(184)	2,364	200	7,584
Other net operating income (exps.)	35	(45)	321	67	(1,350)	2,313	663	2,004
Total operating income	18,623	3,307	1,923	1,997	1,890	3,272	459	31,471
Administrative expenses	(5,094)	(443)	(635)	(663)	(185)	(2,308)	(8,295)	(17,623)
Insurance fund	(656)	(3)	(0)	(57)	(38)	-	-	(754)
Bank tax	-	-	-	-	(208)	-	-	(208)
Impairment charges and net valuation changes	1,543	6,097	2	1,015	(53)	(68)	(131)	8,405
Profit (loss) before cost allocation & tax	14,416	8,958	1,290	2,292	1,406	896	(7,967)	21,291
Net segment revenue from external customers	20,063	9,035	1,885	(128)	(4,324)	4,080	860	31,471
Net segment revenue from other segments	(1,439)	(5,729)	38	2,125	6,214	(809)	(400)	0

At 30 September 2013	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Total segment assets	384,798	184,542	750	3,749	231,095	106,564	(48,965)	862,533
Total segment liabilities	392,607	8,413	863	51,210	225,338	61,548	(37,110)	702,869

Amounts are in ISK million

Business combination

5. **Changes within the group**

5.1 **Loss of control of a subsidiary**

On 10 January 2014 the Bank sold 71.1% of its shareholding in Bláfugl ehf. The entity was classified as a non-current asset held for sale. The Bank has derecognised the assets and liabilities, any non-controlling interests and other components related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item "Profit from discontinued operations, net of income tax".

On 7 February 2014 the Bank sold 72.5% of its shareholding in HTO ehf. The entity was classified as a non-current asset held for sale. The Bank has derecognised the assets and liabilities, any non-controlling interests and other components related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item "Profit from discontinued operations, net of income tax".

On 31 March 2014 the Bank sold 100% of its shareholding in EFF 4 ehf. The entity was classified as a non-current asset held for sale. The Bank has derecognised the assets and liabilities and other components related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item "Profit from discontinued operations, net of income tax".

Quarterly statements

6. Operations by quarters:

	Q3* 2014	Q2* 2014	Q1* 2014	Q4* 2013	Q3* 2013
Net interest income	7,068	6,922	6,646	6,547	7,365
Net fee and commission income	2,849	2,818	2,854	2,849	2,462
Net financial income	83	19	863	2,747	315
Net foreign exchange gain (loss)	352	(12)	(291)	(1,117)	409
Share of profit of associates	-	27	-	-	-
Other net operating income	233	240	1,113	100	314
Administrative expenses	(5,231)	(5,350)	(5,909)	(7,928)	(5,208)
Contribution to the Depositors' and Investors' Guarantee Fund	(272)	(260)	(258)	(262)	(252)
Bank tax	(664)	(623)	(592)	(2,113)	(76)
Loan impairment charges and net valuation changes	65	4,219	1,520	7,894	555
Profit before tax	4,483	8,000	5,946	8,717	5,884
Income tax	(1,255)	(2,156)	(1,394)	(2,501)	(1,570)
Profit for the period from continuing operations	3,228	5,844	4,552	6,216	4,314
Profit (loss) for the period from discontinued operations	307	515	3,744	1,456	(125)
Profit for the period	3,535	6,359	8,296	7,672	4,189

*The half year results were reviewed by the Bank's auditors but the splits between quarters were not audited.

For the nine months ended 30 September 2014 13 Amounts are in ISK million

Financial assets and liabilities

7. The following tables show the carrying value of financial assets and financial liabilities according to their IAS39 classification.

At 30 September 2014	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	22	-	-	135,138	-	135,138
Loans and receivables						
Loans to credit institutions	24	-	-	41,720	-	41,720
Loans to customers	25-26	-	-	608,328	-	608,328
Loans and receivables		-	-	785,186	-	785,186
Bonds and debt instruments						
Listed		52,832	31,335	-	-	84,167
Unlisted		-	1,840	-	-	1,840
Bonds and debt instruments		52,832	33,175	-	-	86,007
Shares and equity instruments						
Listed		5,997	2,869	-	-	8,866
Unlisted		-	2,018	-	-	2,018
Shares and equity instruments		5,997	4,887	-	-	10,884
Derivatives	23	2,165	-	-	-	2,165
Other financial assets		-	-	10,916	-	10,916
Total financial assets		60,994	38,062	796,102	-	895,158
Derivative instruments and short positions	23	8,118	-	-	-	8,118
Deposits from Central Bank	33	-	-	-	35	35
Deposits from credit institutions	33	-	-	-	24,370	24,370
Deposits from customers	34-35	-	-	-	536,104	536,104
Debt issued and other borrowed funds	36	-	-	-	97,714	97,714
Subordinated loans		-	-	-	21,089	21,089
Other financial liabilities		-	-	-	33,394	33,394
Total financial liabilities		8,118	-	-	712,706	720,824

For the nine months ended 30 September 2014 14 Amounts are in ISK million

7. Cont'd

At 31 December 2013	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	22	-	-	111,779	-	111,779
Loans and receivables						
Loans to credit institutions	24	-	-	44,078	-	44,078
Loans to customers	25-26	-	-	554,741	-	554,741
Loans and receivables		-	-	710,598	-	710,598
Bonds and debt instruments						
Listed		41,311	31,598	-	-	72,909
Unlisted		-	2,277	-	-	2,277
Bonds and debt instruments		41,311	33,875	-	-	75,186
Shares and equity instruments						
Listed		3,095	3,322	-	-	6,417
Unlisted		-	2,791	-	-	2,791
Shares and equity instruments		3,095	6,113	-	-	9,208
Derivatives	23	843	-	-	-	843
Other financial assets		-	-	9,036	-	9,036
Total financial assets		45,249	39,988	719,634	-	804,871
Derivative instruments and short positions	23	11,176	-	-	-	11,176
Deposits from Central Bank	33	-	-	-	63	63
Deposits from credit institutions	33	-	-	-	29,626	29,626
Deposits from customers	34-35	-	-	-	489,331	489,331
Debt issued and other borrowed funds	36	-	-	-	89,193	89,193
Subordinated loans		-	-	-	21,890	21,890
Other financial liabilities		-	-	-	22,561	22,561
Total financial liabilities		11,176	-	-	652,664	663,840

Amounts are in ISK million

Fair value information for financial instruments

8. The fair value of a financial instrument is the transaction price that would have been received in selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Where a market price is not readily available, the Bank applies valuation techniques based on estimates and assumptions that are consistent with that which market participants would use in setting a price for the financial instrument. In some instances the Bank uses approximation methods. These approximation methods are explained in more detail below.

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.

Financial instruments at amortised cost

Assets

Loans on the Bank's statement of financial position that are carried at amortised cost consist of two types:

1) Loans whose carrying amount is less than their claim value, due to either impairments or deep discount.
2) Loans whose carrying amount equals the claim value.

Loans in category 1) are specifically valued each quarter and therefore their fair value is fully represented by their carrying amount. The fair value of the loans in category 2) may differ from their carrying amount because the interest rate they carry may not reflect the interest rate that similar new loans would carry. This difference stems from two sources:

a) Credit migration: The debtors may not have the same credit-worthiness they had when the loans' interest rates were last reset and the collateralisation of the loan may have changed.
b) Fixed rate loans: The interest rate level used as a base for pricing fixed rate loans may have shifted.

The Bank calculates the fair value of loans in category 2) by discounting from the carrying amount the resulting interest rate difference from 30 September 2014 to the loan's next interest reset or maturity.

For “Cash and balances with Central Bank” and “Loans to credit institutions” the carrying value is very well approximated by the carrying amount since they are short term in nature.

Liabilities

On the liabilities side most deposits are on demand or carry floating interest rates and as such their fair value equals their carrying amount. For longer term, fixed rate deposits the Bank calculates the fair value with a duration approach, using the difference in each liability´s current rate from the rate that a similar deposit would carry today. For the fair value of "Debt issued and other borrowed funds" the Bank uses an observed market value where it is available. If there is no observable market value the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate and is estimated by comparing the debt's margin with the Bank's current funding premium on similar debt if it is based on a floating rate. The Bank estimates its funding premium based on the interest margin on its issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

The fair value of liabilities in "Subordinated loans" is estimated by comparing the contractual interest margin with the interest margin in the market on the Bank's issuance in foreign currency plus a margin to account for the fact that the subordinated liabilities are junior to the market traded debt.

The following table shows the fair value for the Bank's assets and liabilities recognised at amortised cost.

	Carrying amount 30.9.2014	Fair value 30.9.2014	Carrying amount 31.12.2013	Fair value 31.12.2013
Financial assets:				
Cash and balances with Central banks	135,138	135,138	111,779	111,779
Loans to credit institutions	41,720	41,720	44,078	44,078
Loans to customers	608,328	609,441	554,741	556,068
Total financial assets	785,186	786,299	710,598	711,925
Financial liabilities:				
Deposits from Central Bank	35	35	63	63
Deposits from credit institutions	24,370	24,370	29,626	29,626
Deposits from customers	536,104	536,174	489,331	489,430
Debt issued and other borrowed funds	97,714	97,490	89,193	89,723
Subordinated loans	21,089	21,084	21,890	21,880
Total financial liabilities	679,312	679,153	630,103	630,722

For the nine months ended 30 September 2014 16 Amounts are in ISK million

9. Financial instruments at fair value

The following table shows financial instruments carried at fair value, by valuation method, categorised as at 30 September 2014. The different levels have been defined as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Bank can access at the measurement date.

Level 2: Inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Inputs for the assets or liabilities that are not based on observable market data (unobservable inputs, e.g. internal assumptions).

At 30 September 2014

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	53,563	30,603	1,841	86,007
Shares and equity instruments	8,865	-	2,019	10,884
Derivative instruments	-	2,165	-	2,165
Total financial assets	62,428	32,768	3,860	99,056

Financial liabilities:	Level 1	Level 2	Level 3	Total
Short positions	5,596	81	-	5,677
Shares and equity instruments	26	-	-	26
Derivative instruments	-	2,353	88	2,441
Total financial liabilities	5,622	2,434	88	8,144

The following table shows financial instruments carried at fair value, by valuation method, categorised as at 31 December 2013.

At 31 December 2013

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	42,071	31,836	1,279	75,186
Shares and equity instruments	6,417	-	2,791	9,208
Derivative instruments	-	843	-	843
Total financial assets	48,488	32,679	4,070	85,237

Financial liabilities:	Level 1	Level 2	Level 3	Total
Short positions	9,252	210	-	9,462
Derivative instruments	-	1,629	85	1,714
Total financial liabilities	9,252	1,839	85	11,176

For the nine months ended 30 September 2014 17 Amounts are in ISK million

9. Cont'd

Reconciliation of financial instruments in level 3

	Bonds and debt instruments	Shares and equity instruments	Derivatives
Recorded value at 1 January 2014	1,279	2,791	(85)
Additions/purchases	592	540	-
Sales	(33)	(383)	-
Net gains on financial instruments	2	(169)	(3)
Transfers to level 1 or 2	-	(760)	-
Recorded value at 30 September 2014	1,840	2,019	(88)

The responsibility for the valuation at fair value of financial instruments lies within the relevant business units. The business units are required to assess the valuation of their assets quarterly and present them for the Investment Committee which must give its approval of these valuations. Risk Management is responsible for reviewing the valuations, assessing the extent of market data used and categorising the valuation methods.

Level 3 assets contain primarily unlisted and illiquid equities and bonds and one bond option.

The valuation of level-3 assets is done on a case-by-case basis when the book value exceeds ISK 50 million. The valuation methods are presented in the table below.

One equity instrument, a total of ISK 760 million, was transferred from level 3 to level 1 because it was listed on the domestic market in Q1 2014. Transfers of assets from level 3 to level 1 or 2 are done at the transaction price.

Valuation techniques used in the fair value measurement of level 3 assets and liabilities

Valuation method	Bonds and debt instru-ments	Shares and equity instru-ments	Derivatives	Significant unobservable input	Range of estimates (weighted average) for unobservable inputs	Fair value measurement sensitivity to unobservable inputs
Expected recovery	1,248	298	-	Value of assets	Bonds: 0-75% (32%) Shares: 0-100% (59%)	An increase or decrease in the expected recovery would result in a similar change in the fair value
Discounted cash flow model	592	1,185	-	Shares: Weighted average cost of capital (WACC) Bonds: Yield	Shares: 6-11% (8%) Bonds: 8% (8%)	An increase in the WACC or the yield would result in a lower fair value and a decrease would result in a higher fair value
Net asset value	-	536	-	Value of assets	ISK 0-237m (ISK 27m)	An increase in net asset value would result in a higher fair value and a decrease would result in a lower fair value
Other	-	-	(88)	Bond price volatility	6% (6%)	An increase in the volatility would result in a lower fair value and a decrease would result in a higher fair value
Total assets	1,840	2,019	(88)			

For the nine months ended 30 September 2014 18 Amounts are in ISK million

Offsetting financial assets and financial liabilities

10. Offsetting financial assets and financial liabilities

The table below provides a summary of the financial assets and financial liabilities which are subject to enforceable master netting agreements of similar arrangements, even if they have not been offset in the statement of financial position.

a) Financial assets subject to offsetting, enforceable netting arrangements and similar agreements

	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 30 September 2014	Gross recognised financial assets before balance sheet netting	Balance sheet netting with gross recog-nised financial liabilities	Financial assets recognis-ed on the balance sheet, net	Recognised financial liabilities	Cash collateral received	Financial instruments collateral received	Net amount after consideration of potential effect of netting arrangements	Assets outside the scope of offsetting disclosure requirements	Total assets recognised on the balance sheet
Derivatives	2,165	-	2,165	(272)	(144)	(100)	1,649	-	2,165
Total assets	2,165	-	2,165	(272)	(144)	(100)	1,649	-	2,165
At 31 December 2013									
Derivatives	843	-	843	(60)	(98)	(152)	534	-	843
Total assets	843	-	843	(60)	(98)	(152)	534	-	843

b) Financial liabilities subject to offsetting, enforceable netting arrangements and similar agreements

	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 30 September 2014	Gross recognised financial liabilities before balance sheet netting	Balance sheet netting with gross recog-nised financial assets	Financial liabilities recognis-ed on the balance sheet, net	Recognised financial assets	Cash collateral pledged	Financial instruments collateral pledged	Net amount after consideration of potential effect of netting arrangements	Liabilities outside the scope of offsetting disclosure requirements	Total liabilities recognised on the balance sheet
Derivative instruments and short positions	2,441	-	2,441	(272)	-	(955)	1,214	5,677	8,118
Total liabilities	2,441	-	2,441	(272)	-	(955)	1,214	5,677	8,118
At 31 December 2013									
Derivative instruments and short positions	1,714	-	1,714	(60)	-	-	1,654	9,462	11,176
Total liabilities	1,714	-	1,714	(60)	-	-	1,654	9,462	11,176

Amounts are in ISK million

Net interest income

11. Net interest income is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Interest income:				
Cash and balances with Central Bank	1,739	1,317	5,117	3,354
Loans and receivables	10,540	11,313	31,699	36,007
Financial assets held for trading	595	308	1,363	709
Financial assets designated at fair value through profit or loss	399	417	1,256	1,371
Other assets	45	44	144	73
Total interest income	13,318	13,399	39,579	41,514
Interest expense:				
Deposits from credit institutions and Central Bank	(119)	(130)	(382)	(418)
Deposits from customers	(4,487)	(4,273)	(13,307)	(13,814)
Borrowings	(1,310)	(1,268)	(4,148)	(4,307)
Subordinated loans	(226)	(247)	(688)	(715)
Other financial liabilities	(73)	(78)	(253)	(257)
Other interest expense	(35)	(38)	(165)	(120)
Total interest expense	(6,250)	(6,034)	(18,943)	(19,631)
Net interest income	7,068	7,365	20,636	21,883

Net fee and commission income

12. Net fee and commission income is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Fee and commission income:				
Asset management	397	325	1,224	1,005
Investment Banking and brokerage	399	443	1,486	1,453
Payment processing	3,093	2,753	8,537	7,658
Loans and guarantees	325	323	961	867
Other fees and commissions income	324	397	1,032	1,179
Total fees and commission income	4,538	4,241	13,240	12,162
Commission expenses:				
Interbank charges	-	(234)	(156)	(694)
Brokerage	(25)	(31)	(95)	(96)
Clearing and settlement	(1,655)	(1,504)	(4,439)	(3,738)
Other commission expenses	(9)	(10)	(29)	(50)
Total commission expenses	(1,689)	(1,779)	(4,719)	(4,578)
Net fee and commission income	2,849	2,462	8,521	7,584

Amounts are in ISK million

Net financial income

13. Net financial income is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Net (loss) gain on financial instruments held for trading	(26)	223	32	622
Net gain on financial instruments designated at fair value through P&L	109	92	933	1,243
Net financial income	83	315	965	1,865

14. Net gain (loss) on financial instruments designated at fair value through profit or loss is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Shares	83	66	966	1,358
Bonds	26	26	(33)	(115)
Net gain (loss) on financial instruments designated at fair value through P&L	109	92	933	1,243

Net foreign exchange gain (loss)

15. Net foreign exchange gain (loss) is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Assets:				
Cash and balances with Central Bank	1	(15)	(40)	(92)
Financial assets held for trading	(317)	174	(1,215)	2,919
Loans to credit institutions	1,264	(268)	747	(4,388)
Loans to customers	1,319	905	(803)	(6,040)
Other assets	373	81	447	95
Total assets	2,640	877	(864)	(7,506)
Liabilities:				
Deposits from credit institutions	(127)	88	(47)	222
Deposits from customers	(2,212)	(168)	(507)	4,598
Subordinated loan	189	(316)	801	901
Debt issued and other borrowed funds	219	-	1,062	-
Other liabilities	(357)	(50)	(395)	17
Total liabilities	(2,288)	(446)	914	5,738
Unadjusted net foreign exchange loss	352	431	50	(1,768)
Foreign exchange reversal on loans to customers with ISK cash flow (see Note 19)	-	(22)	-	462
Net foreign exchange gain (loss)	352	409	50	(1,306)

Other net operating income

16. Other net operating income is specified as follows:

	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Service level agreement fees	68	93	201	261
Legal cost and fees	35	46	101	137
Rental income	31	24	109	109
Gain from sale of buildings	-	-	-	549
Rental income on foreclosed mortgages	63	110	237	238
Other net operating income	36	41	938	148
Other net operating income	233	314	1,586	1,442

For the nine months ended 30 September 2014 21 Amounts are in ISK million

Administrative expenses

17. Administrative expenses are specified as follows:	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Salaries and related expenses	2,930	2,851	9,811	9,871
Other administrative expenses	2,115	2,148	6,100	7,068
Depreciation and amortisation	186	209	579	684
Administrative expenses	5,231	5,208	16,490	17,623

Salaries and related expenses

18. Salaries and related expenses are specified as follows:	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Salaries	2,242	2,178	7,363	7,531
Pension and similar expenses	322	300	1,102	1,030
Social security charges and financial activities tax	335	350	1,087	1,168
Other	31	23	259	142
Salaries and related expenses	2,930	2,851	9,811	9,871

Loan impairment charges and net valuation changes

19. Loan impairment charges and net valuation changes:	2014 1.7-30.9	2013 1.7-30.9	2014 1.1-30.9	2013 1.1-30.9
Impairment charged to the income statement:				
Specific impairment losses on financial assets	(700)	(1,142)	(1,472)	(8,579)
Impairment of foreign exchange loss	-	(22)	-	462
Net specific impairment losses on financial assets	(700)	(1,164)	(1,472)	(8,117)
Collective impairment	472	(48)	825	(66)
Total impairment charged to the income statement (see Note 27)	(228)	(1,212)	(647)	(8,183)
Net valuation changes on loans:				
Income due to revised estimated future cash flow from loans	293	1,745	6,451	17,050
Net specific impairment losses on financial assets	(700)	(1,164)	(1,472)	(8,117)
Foreign exchange loss *	-	22	-	(462)
Net valuation changes on loans	(407)	603	4,979	8,471
Collective impairment	472	(48)	825	(66)
Loan impairment charges and net valuation changes	65	555	5,804	8,405

* In 2013 foreign exchange gain on foreign currency loans to customers with revenue and cash flows in ISK was impaired and offset against total foreign exchange gain as per Note 15.

Amounts are in ISK million

Effective income tax rate

20. Income tax for the nine month period ended 30 September 2014 is calculated at 20%. Special financial activities tax (FAT) is calculated as 6% of taxable profits above ISK 1 billion. The effective income tax rate in the Bank's income statement is 26.1% for the nine months ended 30 September 2014. The difference is specified as follows:

Income tax recognised in the income statement is specified as follows:	2014 1.1-30.9	2013 1.1-30.9
Current tax expense	3,370	4,377
Special financial activities tax	960	1,164
Difference in prior year's imposed and calculated income tax	2	2
Deferred tax assets	474	(178)
Total	4,806	5,365

The effective income tax rate is specified as follows:	2014 1.1-30.9		2013 1.1-30.9	
Profit before tax	18,430		21,291	
Income tax calculated on profit before tax	3,686	20.0%	4,258	20.0%
Special financial activities tax	960	5.2%	1,164	5.5%
Non-deductable expenses	311	1.7%	59	0.3%
Income not subject to tax	(744)	(4.0%)	(337)	(1.6%)
Correction in accordance with ruling on prior year's taxable income	(14)	(0.1%)	27	0.1%
Other differences	607	3.3%	194	0.9%
Effective income tax	4,806	26.1%	5,365	25.2%

Earnings per share

21. Earnings per share are specified as follows:

	2014 1.1-30.9	2013 1.1-30.9
Net profit of the equity holders of the parent, according to the statement of comprehensive income	17,826	15,349
Average outstanding shares:		
Weighted average number of outstanding shares for the period, million	10,000	10,000
Average outstanding shares, million	10,000	10,000
Basic earnings per share	1.78	1.53
Diluted earnings per share	1.78	1.53

Amounts are in ISK million

Cash and balances with Central Bank

22. Specification of cash and balances with Central Bank:

	30.9.2014	31.12.2013
Cash on hand	2,636	2,472
Balances with Central Bank other than mandatory reserve deposits	13,166	6,619
Term Deposit	109,943	-
Certificates of deposits	-	99,085
Included in cash and cash equivalents	125,745	108,176
Mandatory reserve deposits with Central Bank	9,393	3,603
Cash and balances with Central Bank	135,138	111,779

The average balance of the Central bank current account for each month must be equivalent to at least mandatory reserve deposits, which amounted to ISK 9,393 million for September 2014 (December 2013: ISK 8,153 million).

The Central Bank's auctions of 28-day Certificates of deposit have been discontinued. Instead, financial institutions that engage in transactions with the Central Bank are offered two types of term deposits that are eligible as collateral for Central Bank facilities.

Derivative instruments and short positions

23. Derivative instruments and short positions:

At 30 September 2014

	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	183	3,100	1,118	16,750
Cross currency interest rate swaps	1,443	28,922	1,069	20,216
Equity forwards	269	2,055	36	509
Foreign exchange forwards	166	6,391	96	2,321
Foreign exchange swaps	26	1,234	20	3,865
Bond forwards	78	3,953	14	1,840
Bond options	-	-	88	25,000
Derivatives held for trading	2,165	45,655	2,441	70,501
Short positions in listed bonds	-	-	5,677	-
Total	2,165	45,655	8,118	70,501

At 31 December 2013

	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	21	2,000	1,364	19,500
Cross currency interest rate swaps	525	28,240	28	6,585
Equity forwards	21	7	182	104
Foreign exchange forwards	197	6,498	34	712
Foreign exchange swaps	42	1,176	7	3,193
Bond forwards	37	1,987	14	2,065
Bond options	-	-	85	25,000
Derivatives held for trading	843	39,908	1,714	57,159
Short positions in listed bonds	-	-	9,462	-
Total	843	39,908	11,176	57,159

Amounts are in ISK million

Loans

24. Loans to credit institutions:

	30.9.2014	31.12.2013
Money market loans	15,627	13,821
Bank accounts	26,093	30,257
Loans to credit institutions	41,720	44,078

25. Loans to customers:

	30.9.2014	31.12.2013
Loans to customers at amortised cost	608,328	554,741
Loans to customers	608,328	554,741

26. Loans to customers at amortised cost:

At 30 September 2014

	Gross amount	Specific impairment allowance	Loans less impairment allowance
Loans to customers:			
Individuals	266,797	(6,293)	260,504
Commerce and services	82,266	(3,925)	78,341
Construction	20,027	(1,901)	18,126
Energy	3,636	-	3,636
Financial services	72	-	72
Industrial and transportation	61,855	(1,235)	60,620
Investment companies	20,029	(2,873)	17,156
Public sector and non-profit organisations	11,392	(18)	11,374
Real estate	82,473	(1,779)	80,694
Seafood	81,956	(1,296)	80,660
Loans to customers before collective impairment allowance			611,183
Collective impairment allowance			(2,855)
Loans to customers	630,503	(19,320)	608,328

Amounts are in ISK million

26. Cont'd

At 31 December 2013

	Gross amount	Specific impairment allowance	Loans less impairment allowance
Loans to customers:			
Individuals	263,446	(8,402)	255,044
Commerce and services	85,340	(3,818)	81,522
Construction	20,656	(2,016)	18,640
Energy	3,614	-	3,614
Financial services	34	-	34
Industrial and transportation	48,224	(1,791)	46,433
Investment companies	13,839	(3,533)	10,306
Public sector and non-profit organisations	6,943	(49)	6,894
Real estate	69,732	(3,085)	66,647
Seafood	70,829	(1,540)	69,289
Loans to customers before collective impairment allowance			558,423
Collective impairment allowance			(3,682)
Loans to customers	582,657	(24,234)	554,741

27. Financial assets - impairments

The following table shows the movement in the provision for impairment losses for loans and receivables.

	Individually assessed	Collectively assessed	Total
At 1 January 2014	24,234	3,682	27,916
Amounts written-off	(6,439)	-	(6,439)
Recoveries of amounts previously written-off	1,107	-	1,107
Principal credit adjustment	(1,055)	-	(1,055)
Charged to the income statement	1,472	(825)	647
At 30 September 2014	19,320	2,855	22,175

	Individually assessed	Collectively assessed	Total
At 1 January 2013	45,191	1,738	46,929
Amounts written-off	(19,254)	4	(19,251)
Recoveries of amounts previously written-off	1,240	-	1,240
Principal credit adjustment	(8,824)	-	(8,824)
Charged to the income statement	5,881	1,940	7,821
At 31 December 2013	24,234	3,682	27,915

	2014 1.1-30.9	2013 1.1-30.9
Impairment charged to the income statement:		
Loans to customers	647	8,183
Impairment charged to the income statement (see Note 19)	647	8,183

Individually assessed allowance comprises impairment for financial assets that are assessed individually and collectively assessed allowance comprises estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics (see Note 2.5).

Amounts are in ISK million

Investment in associates

28. Changes in investments in associates:

	30.9.2014	31.12.2013
Investment in associates at the beginning of the year	1,563	503
Additions during the period	17	37
Transfers	-	1,020
Revaluation	(7)	-
Share of results	27	3
Decrease of associate	(803)	-
Investments in associates at the end of the period	**797**	**1,563**

Investment in subsidiaries

29. Significant subsidiaries:

	Location	Ownership
Borgun hf., Ármúla 30, 108 Reykjavík	Iceland	62.2%
Íslandssjódir hf., Kirkjusandi 2, 105 Reykjavík	Iceland	100%
Midengi ehf., Lækjargötu 12, 155 Reykjavík	Iceland	100%
Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
D-1 ehf., Kirkjusandi 2, 105 Reykjavík	Iceland	100%
Geysir Green Investment Fund slhf., Hafnargötu 90, 230 Reykjanesbæ	Iceland	100%
Fergin ehf., Hesthálsi 6-8, 110 Reykjavík	Iceland	80%
Frumherji hf., Hesthálsi 6-8, 110 Reykjavík	Iceland	80%
26 other subsidiaries (SME)		

Related party disclosures

30. Ultimate controlling party

The Bank has determined that ISB Holding is the ultimate controlling party of the Bank with GLB Holding having significant influence. This is reflected in the related party transactions.

Entities which are controlled, jointly controlled or significantly influenced by the government (state-controlled entities) are not considered as being a related party if neither entity actually influenced the other and if the state did not actually influence either entity with regards to transactions between them. The Bank's transactions with state-controlled entities during the period were based on general business terms of the Bank.

Related party transactions

The Bank has a related party relationship with its associates, the Board of Directors of the parent company and the ulitmate controlling party, the executive vice presidents of the Bank, close family members of individuals referred to herein and entities with significant influence as the largest shareholders of the Bank.

All loans to employees are provided on general business terms of the Bank. Included in assets are loans to key management.

Related parties have transacted with the Bank during the period as follows:

		30.9.2014			31.12.2013	
	Assets	Liabilities	Total	Assets	Liabilities	Total
CEO and Man. Directors (incl. comp. owned by them)	223	(131)	92	178	(285)	(107)
Members of the Board (incl. comp. owned by them)	8,511	(5,286)	3,225	462	(2,393)	(1,931)
Associated companies and other related parties	210	(4,582)	(4,372)	288	(3,824)	(3,536)
Total	**8,944**	**(9,999)**	**(1,055)**	**928**	**(6,502)**	**(5,574)**

	30.9.2014	31.12.2013
Guarantees	539	478
Loan commitments, overdraft and credit card commitments	331	124

Impairment allowances of ISK -155 million (2013: ISK 27 million) were recognised in the period against balances outstanding with related parties.

No share option programmes were operated during the reporting period 1 January - 30 September 2014.

For the nine months ended 30 September 2014 27 Amounts are in ISK million

Non-current assets and disposal groups held for sale

31. Specification of non-current assets and disposal groups held for sale:

	30.9.2014	31.12.2013
Repossessed collateral	8,182	10,722
Assets of disposal groups classified as held for sale	14,715	36,384
Total	22,897	47,106

Repossessed collateral:		
Land and property	7,453	8,544
Industrial equipment and vehicles	44	34
Shares and equity instruments	685	2,144
Total	8,182	10,722

Assets of disposal groups classified as held for sale:	30.9.2014	31.12.2013
Cash	471	535
Equity instruments	805	775
Properties and equipment	983	954
Receivables	883	785
Tax assets	78	225
Properties	1,952	13,001
Assets classified as held for sale	5,692	14,727
Other assets	3,851	5,382
Total	14,715	36,384

Liabilities associated with assets classified as held for sale:	30.9.2014	31.12.2013
Payables	228	502
Deferred tax liabilities	122	644
Income tax payable	24	416
Borrowings	2,802	7,148
Other liabilities	389	746
Total	3,565	9,456

Other assets

32. Other assets are specified as follows:

	30.9.2014	31.12.2013
Receivables	4,474	4,816
Unsettled securities transactions	8,029	5,099
Accruals	720	731
Prepaid expenses	363	200
Other assets	285	313
Other assets	13,871	11,159

For the nine months ended 30 September 2014 28 Amounts are in ISK million

Deposits from Central Bank and credit institutions

33. Deposits from Central Bank and credit institutions are specified as follows:

	30.9.2014	31.12.2013
Repurchase agreements with Central Bank	35	63
Deposits from credit institutions	24,370	29,626
Deposits from Central Bank and credit institutions	24,405	29,689

Deposits from customers

34. Deposits from customers are specified by type as follows:

	30.9.2014	31.12.2013
Demand deposits	446,627	394,345
Time deposits	89,477	94,986
Deposits from customers	536,104	489,331

35. Deposits from customers are specified by owners as follows:

	30.9.2014		31.12.2013	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	7,936	2%	5,086	1%
Municipalities	8,837	2%	4,193	1%
Companies	321,768	60%	292,792	60%
Individuals	197,563	36%	187,260	38%
Deposits from customers	536,104	100%	489,331	100%

Debt issued and other borrowed funds

36. Specification of debt issued and other borrowed funds:

	30.9.2014	31.12.2013
Non-listed issued bonds	32,533	46,758
Listed issued bonds	63,802	41,006
Loans from credit institutions	2	2
Other debt securities	1,377	1,427
Debt issued and other borrowed funds	97,714	89,193

Amounts are in ISK million

Other liabilities

37. Specification of other liabilities:

	30.9.2014	31.12.2013
Accruals	3,089	3,163
Liabilities to retailers for credit card provision	24,534	20,563
Provision for effects of court rulings*	3,790	4,699
Provision for estimated losses from guarantees and others**	739	2,211
Capital gains tax	578	1,816
Unsettled securities transactions	8,240	840
Deferred income	201	206
Sundry liabilities	3,383	3,632
Other liabilities	44,554	37,130

	Provision for effects of court rulings*	Provision for estimated losses from guarantees and others**	Total
At 1 January 2014	4,699	2,211	6,910
Provision used during the year	(909)	-	(909)
New provisions and reversed provisions during the year	-	(1,472)	(1,472)
At 30 September 2014	3,790	739	4,529

Equity

38. Authorised share capital of the Bank is 10,000m ordinary shares of ISK 1 each. At 30.9.2014 paid up share capital totalled ISK 65,000m which is the total stated share capital of the Bank.

Total share capital:

	30.9.2014	31.12.2013
Ordinary share capital	10,000	10,000
Share premium account	55,000	55,000
Total share capital	65,000	65,000

Balance of custody assets

39. Balance of custody assets:

	30.9.2014	31.12.2013
Custody assets	656,958	754,166

Amounts are in ISK million

Contingencies

40. **Netting agreement**

When certain assets and obligations were transferred from Glitnir to the Bank, the FME (Financial Supervisory Authority) ruled that customers would, upon liquidation of Glitnir, maintain their right to claim netting of assets and liabilities held by Glitnir prior to the Bank's acquisition.

The Bank made an agreement with Glitnir that the latter will compensate the Bank for any losses incurred as a result of netting of assets and liabilities. The claims in question are unlikely to affect either the net asset value or the earnings of the Bank.

Following the Bank's acquisition of Byr hf. the Bank is in the position of having to honour a clients' right to claim netting of assets and liabilities held by Byr sparisjóður, prior to the founding of Byr hf., as later acquired by the Bank. Arrangements, comparable to the agreement between the Bank and Glitnir, have been made between Byr sparisjóður and the Bank.

Allocation of liens, guarantees and comparable rights

When certain assets and obligations were transferred from Glitnir to the Bank, the FME ruled that the Bank would take over all rights used to secure the performance of obligations of the debtors of Glitnir, including all liens, guarantees and other comparable rights connected to the claims of the Bank.

The Bank should, however, be accountable to Glitnir for specific collateral of its customers, as applicable, due to claims and derivatives which were not transferred to the Bank. The Bank has, in accordance with this decision, transferred to Glitnir certain collateralised obligations of customers. One customer filed a lawsuit against the Bank with the Reykjavík District Court challenging the Bank's decision to transfer the customer's money market deposit to Glitnir, which the Bank, in good faith, identified as collateral for a foreign exchange future contract. The claim was for approximately ISK 450 million. The District Court ruled in favour of the Bank and the ruling was confirmed by the Iceland Supreme Court after appeal. Any future allocation of collaterals will be made under an agreement with Glitnir, whereby Glitnir indemnifies the Bank against any future claims arising from the transfer of such rights.

Indexed loans

Three court cases have been filed, one against the Bank and the others against Landsbankinn and the Housing Financing Fund (HFF), challenging the legality of fixing the principal of a mortgage to the consumer price index (CPI). Such indexation has been the industry standard in Iceland for at least 30 years. However, the method of calculating the index has changed over the years, with the most recent change being introduced in 1995. The courts have upheld a motion by the plaintiffs in both cases to seek an opinion of the EFTA court on some key issues.

The case against the Bank is based on the indexation being in violation of the EU Directive 93/13/EU on unfair terms in consumer loan contracts. The Directive does not prohibit the use of price indexation, provided that the consumer is adequately informed about the method of calculating the index and the factors that affect changes in the index. Thus, the case does not challenge the indexation as such, but only the context in which it is deployed. It will not affect corporate customers. Being a directive that does not require full harmonisation, it was not adopted by Iceland in its entirety. Instead, the existing contract law was amended by adding four new articles. The Supreme Court accepted the motion introduced by the plaintiff on seeking the opinion of the EFTA court on the implications of the differences between the directive and the local law. The case was heard on 9 April 2014 and the opinion was published on 28 August 2014. In short, the Court stated that:

1. The EU Directive 93/13/EEC does not generally prohibit contractual terms on the indexation of mortgage loans in contracts between a supplier and a consumer. It is for the referring court to assess whether the term at issue is deemed to be unfair.
2. The Directive does not limit the discretion of an EEA State to determine, whether through legislation or by means of administrative regulation, the factors that may cause in a pre-determined index, such as the Icelandic consumer price index, as well as the methods for measuring those changes, provided they are explicitly described in the contract.
3. It is for the competent court to establish whether a particular contract term has been negotiated individually within the meaning of the Directive.
4. It is for the competent court to establish whether a contract term relating to the indexation of repayment instalments of a loan to finance real estate purchases must be regarded as having been explicitly and comprehensibly described to the consumer.
5. Article 6(1) of the Directive must be interpreted as meaning that, where a national court considers that a given term is unfair within the meaning of the Directive, that court must ensure that such a clause is not binding to the consumer provided that the contract is capable of continuing in existence without the unfair term, in so far as, in accordance with the rules of domestic law, such a continuity of the contract is legally possible.

Thus, the general conclusion of the EFTA court is that indexation is permissible in consumer contracts, but Icelandic courts must decide if it is properly applied and described to the consumer. The subsequent court proceedings of the case have not started. Domestic courts are not obliged to adopt an opinion of the EFTA court.

The possible effect on the Bank has only been estimated on very broad terms, but any downgrading of the indexation could significantly affect the Bank and other home mortgage lenders in Iceland.

40. Cont'd

The Landsbanki case was based on the argument that CPI indexation makes a mortgage a complex financial instrument as defined in the Act on Securities Transactions no. 108/2007 (MiFid Directive) and therefore unsuitable for retail customers. However, the Supreme Court has recently sustained a motion previously mentioned on seeking the opinion of the EFTA court on several issues relating to the implementation of both the Directive on consumer loans (90/88/EBE) and on unfair terms in consumer loan contracts. The court also commented on the MiFID argument stating that the loan instrument could not be categorised as a derivative. Thus the courts have more or less dismissed the original argument, making the case very similar to the one the Bank is defending. However, the EFTA court has yet to render an opinion on one key issue. The issue is identical to the one previously decided on by the Consumer Agency (see below).

The Consumer Agency (the “Agency”) has published its decision on a matter regarding the terms of, and information relating to the granting of, a consumer price indexed (“CPI Indexed”) mortgage by Íslandsbanki in 2005. Although the Agency considers the granting of CPI Indexed mortgages to be legal, it found that the procedures applied by Íslandsbanki, and its predecessor, in calculating the annual percentage rate of charge (APRC) in the payment plan to be in breach of Article 12 of Act no. 121/1994 on Consumer Credit, as well as Article 6 of the same Act and moreover Article 5 of Act no. 57/2005, on the surveillance of unfair business practices and market transparency. The Agency believed the breach to have occurred when the Bank made the assumption of zero-inflation in the calculation of the APRC, or in other words assumed that the CPI would remain unchanged until the end of the contract.

The Bank's argument is based on the wording of the previous Consumer Credit Act. According to Article 12, such an assumption is permissible in the case of loans with variable interest rates, and states that the annual percentage rate of charge shall be calculated on the assumption that the price level, interest rate and other charges will remain unchanged until the end of the credit agreement. Before the enactment of the new Act on Consumer Credit in 2013, the Bank's procedures in these instances were based on the interpretation of the words "remain unchanged", in Article 12 of the Act on Consumer Credit, meaning that an unaltered consumer price index should be assumed. A quick survey of the market showed that all major lenders applied the same method. The Agency has taken the Article's wording to mean that the same level of inflation as in the month at the time of the granting of the loan should be assumed. The Bank disagrees with the Agency's decision in this respect. The procedure in question has been upgraded following the implementation of the new Act on Consumer Credit. The Bank has appealed the Agency's decision to the Consumer Appeals Committee. A final decision is not expected until the EFTA court has decided on the same issue, probably before year end 2014 . Recent court judgements seem to agree with the opinion of the lenders. The ruling of the Consumers Appeals Committee can be referred to the courts.

Variable rate loans

The Consumer Agency (the “Agency”) published in September its decision in a matter regarding the terms of, and information relating to the granting of, a consumer mortgage by Íslandsbanki in 2005 with interest reset terms. The Agency found that the terms offered by Íslandsbanki, and its predecessor, regarding the method and conditions of resetting interest to be in breach of Articles 6 and 9 of Act no. 121/1994 on Consumer Credit (superseded in November 2013) The Agency believes that the terms offer insufficient explanation on how or what can affect the decision on the revised interest rate. To support its decision, the Agency cites among other things a former 2009 decision of the Consumer Appellate Committee. The Bank has stated officially that it disagrees with the Agency’s decision on the point that the law requires such detailed explanations on the outcome of a change in interest rate. The terms explicitly state the time period when the Bank can change the interest rate (every 5 years) and, moreover, that the borrower can settle the loan without a pre-settlement charge if he or she is not content with the change. The precedent quoted by the Agency did not involve such terms.

According to Article 12 of the former Consumer Credit Act, it is permissible to calculate the annual percentage rate of charge on the assumption that the price level, interest rate and other charges will remain unchanged to the end of the credit agreement. Thus, the Bank notified each borrower on the effects of variable interest rates, for example the payment schedule document did state: “Please note that this schedule is based on the present CPI, interest rate and service charges list in effect at Íslandsbanki at the time of issuance”. The notification is based on the aforementioned Article 12 of the preceding law on consumer loans.

There is no doubt that similar terms were applied by all major financial institutions serving the housing loan market, including the Housing Financing Fund (HFF). The Bank has to date not enforced the terms in question to a great extent and has decided to postpone the next scheduled interest rate change. Customers have the option of receiving better terms by restructuring their loans with the appropriate documentation, fully adapted to the new legislation on consumer loans. The decision of the Agency has been appealed to the Consumer Appellate Committee.

Foreign currency loans

Several rulings of the Supreme Court of Iceland during the years 2010 to 2014 in relation to foreign currency-linked loans have affected the Bank. Most important of these rulings was a ruling in June 2010 on the illegality of the principal of loans in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates.

The effects of these rulings and the subsequent corrections to the recalculations of illegal foreign currency-linked loans are reflected in the value of the loans in the Bank's Consolidated Financial Statements. The amount owed to customers with regards to paid-up loans is reflected in the Bank's provisions, see Note 37.

The court rulings combined have effectively reduced the uncertainty regarding which foreign currency loans are illegal and how they should be recalculated. The Bank made an announcement to the effect that it would recalculate illegally foreign currency-linked loans, outstanding as well as paid-up loans, in line with the instructions given by the rulings. This process is in its final stages, the last mass-recalculation in process involves corporate financial leasing contracts.

40. Cont'd

As for later developments, some former rulings were based on the Bank being the dominant and expert party in the contractual relationship. Recent judgements imply that former rulings do not necessarily apply to other financial institutions or large companies as counterparties, especially if those conduct their business in part abroad or deal in foreign currency contracts on a regular basis. Moreover, the Supreme Court found in favour of a bank in a case in which a customer did not pay instalments on a regular basis and deviated significantly from the original payment schedule. Consequently, the Bank revised its categorisation on which loans should be recalculated. The result did only slightly differ from the previous categorisation.

The uncertainty that still exists is more or less embedded in two court cases in which the plaintiffs contest the legality of three corporate Glitnir/Íslandsbanki loan contracts. Although such contracts are not great in numbers, they carry the greatest sums. Thus, the value of the precedent is significant (approx. 3-5 billion ISK in the two cases). In the district court the Bank argued that the contracts differ from those previously ruled on by way of the method by which the loan was disbursed. If the contract says that the debtor can explicitly request payment in any currency and the contract is fulfilled in that manner, the maximum contract amount can be presented in ISK without offsetting the foreign currency loan validity of the contract. The district court ruled in favour of the Bank in both cases, finding the contracts in question valid and fully enforceable as foreign denominated loans. Both have summarily been appealed by the debtors. A final judgement on these cases is expected by the Supreme Court in the fourth quarter of 2014.

Settlement of the 2011 Byr acquisition

The Bank acquired Byr (a former Savings Bank) in 2011 from the Bank's Winding-up Committee (the "Committee") and the Icelandic Ministry of Finance and Economic Affairs (the "Ministry"). According to standard practice, the Bank retained the right to re-evaluate the value of the assets acquired and subsequently to demand a refund if the assets did not live up to expectations. A claim was filed with the Committee in June 2013 amounting to ISK 6,943 million plus interest. The claim is filed as a priority claim, according to Article 110 of Law 21/1991, to be set off against the bond the Bank owes Byr amounting to ISK 5,834 million (due in November 2014 and 2015). The Committee rejected the claim with a letter dated 30 September 2013. It was decided at a creditors meeting in December 2013 that the Committee would refer the dispute to the District Court of Reykjavík. A formal claim amounting to ISK 911 million plus interest was filed with the Ministry on 24 September. Both claims, on the Ministry and on the Committee, have been filed with the District Court of Reykjavík. Furthermore, the District Court has appointed two independent professionals, at the request of Íslandsbanki, to perform a formal evaluation of the Bank's claim on the Ministry and the Committee. The evaluation is expected to be finalised before the end of the second quarter of 2015. The Bank has not recognised any revenues relating to this claim in its Consolidated Financial Statements.

Formal investigation by the Icelandic Competition Authority regarding alleged violation of competition law by Íslandsbanki

The Icelandic Competition Authority ("ICA") has initiated an investigation concerning alleged violations of the Competition law by the Bank. Details of the investigation remain confidential.

The ICA has requested and received information from Íslandsbanki and has, following their review, sent the Bank an opposition document. It is alleged that the Bank has violated Article 11 of the Competition Act, i.e. Act no. 44/2005 and Article 53 of the EEA Agreement. The ICA considers the violations to be extensive, to have been in existence for a considerable period of time and to concern important markets. The opposition document is one stage in the processing of the case and does not comprise a final administrative decision.

The Bank has presented its observations on the opposition document and will further cooperate with the ICA to resolve the case. However, should the ICA's findings be final, sanctions may come into consideration, as per Article 37 of the Competition Act.

Formal request for information by the EFTA Surveillance Authority into alleged unlawful state aid to Íslandsbanki

On 22 October 2013 the EFTA Surveillance Authority ("ESA"), following a complaint dated 23 September 2013, formally requested information on alleged unlawful state aid granted to Íslandsbanki hf. through long term funding at favourable interest rates by the Central Bank of Iceland.

The Icelandic authorities and the Bank have sent all relevant information and their observations as per the ESA request, in order to determine whether or not the measures complained of involve state aid based on interpretation of Article 61 of the EEA Agreement, or qualify for an exemption under Article 61(2) or (3) of the EEA Agreement. Both parties state that the measures, which are the topic of the complaint, cannot be considered to be state aid within the meaning of Article 61 (1) of the EEA Agreement, as the funding in question was provided at what has to be considered market rates at the time and where indeed favourable to the Central Bank. However, should ESA disagree, then the measures must be considered state aid compatible with the functioning of the EEA Agreement under Article 61(3) (b) of the EEA Agreement.

The possible effect on the Bank, should ESA decide that the measures constitute unlawful state aid, has not been determined. At present, no timeframe has been given as to when the Icelandic authorities may expect ESA's decision.

The Depositors' and Investors' Guarantee Fund

In 2010, under a previous legislation, the Bank was required to grant the the Depositors' and Investors' Guarantee Fund a declaration of guarantee in case the fund's assets did not meet the required minimum amount. Accordingly, the Bank issued a declaration of guarantee for future obligations amounting to ISK 3,724 million. The Bank did not recognise a liability in its statement of financial position in respect of this declaration which is now considered void. The amended legislation does not stipulate a requirement for such a declaration of guarantee. However, there remains some uncertainty as to its validity in relation to losses originated in the period from October 2008 to June 2012.

Events after the end of the reporting period

41. No events have arisen after the reporting period that require amendments or additional disclosures in the Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2014.

Risk Management

42. Risk governance

The Bank is exposed to various risks and managing these risks is an integral part of the Bank's operations. More information about the Bank's risk management and risk assessment processes is available in the Risk Report 2013. The Risk Report is available at the Bank's website under investor relations: www.islandsbanki.is/riskreport

Credit risk

43. Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Bank or to otherwise fail to perform as agreed.

This risk comprises default risk, recovery risk, country risk, settlement risk and credit concentration risk.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Credit risk arises principally from the Bank's loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as guarantees, loan commitments and derivatives.

44. Maximum credit exposure

The Bank's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position before the collective impairment allowance is subtracted, see Note 26. The maximum exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. The maximum credit exposure for a derivative contract is calculated by adding future credit exposure to the market value of the contract as described in Annex III of the European Parliament directive 2006/48/EC (Basel II).

The industry breakdown shows the Bank's credit exposure by industry classification. The breakdown follows an internal industry classification which is based on the Icelandic ISAT2008 that derives from the European NACE Rev. 2 classification standard.

The Bank's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

Credit risk exposure

44. Cont'd

Maximum credit exposure 30.9.2014

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transporta-tion	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	135,138	-	-	-	-	-	-	-	-	-	135,138
Derivatives	39	-	477	-	991	1,923	15	75	334	345	-	4,199
Bonds and debt instruments	-	78,210	100	-	292	5,802	-	928	247	428	-	86,007
Loans to credit institutions	-	-	-	-	-	41,720	-	-	-	-	-	41,720
Loans to customers:	260,504	-	78,341	18,126	3,636	72	60,620	17,156	11,374	80,694	80,660	611,183
Overdrafts	13,306	-	11,611	3,659	32	13	4,159	664	964	2,107	2,001	38,516
Credit cards	14,740	-	1,393	191	5	20	395	31	178	58	45	17,056
Mortgages	184,263	-	-	-	-	-	-	-	-	-	-	184,263
Leases	10,330	-	16,153	2,621	-	1	6,077	214	215	1,275	234	37,120
Other loans	37,865	-	49,184	11,655	3,599	38	49,989	16,247	10,017	77,254	78,380	334,228
Off-balance sheet items:												
Financial guarantees	1,534	-	2,443	2,138	-	1,170	1,296	44	40	158	483	9,306
Undrawn loan commitments	-	-	640	6,195	10,003	-	3,243	685	7,500	4,269	269	32,804
Undrawn overdraft	8,730	-	6,871	1,682	24	3,404	3,151	231	1,871	913	1,318	28,195
Credit card commitments	24,146	-	3,324	468	28	70	861	161	873	184	139	30,254
Total maximum credit exposure	294,953	213,348	92,196	28,609	14,974	54,161	69,186	19,280	22,239	86,991	82,869	978,806

Amounts are in ISK million

44. Cont'd

Maximum exposure 31.12.2013

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transporta- tion	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	111,779	-	-	-	-	-	-	-	-	-	111,779
Derivatives	10	1,036	53	-	520	434	131	43	-	4	137	2,368
Bonds and debt instruments	-	67,268	-	-	58	6,326	-	967	116	451	-	75,186
Loans to credit institutions	-	-	-	-	-	44,078	-	-	-	-	-	44,078
Loans to customers:	255,044	-	81,522	18,640	3,614	34	46,433	10,306	6,894	66,647	69,289	558,423
Overdrafts	14,885	-	9,862	4,109	1	20	4,000	290	1,746	2,208	2,318	39,439
Credit cards	16,008	-	1,265	154	4	14	369	28	140	51	47	18,080
Mortgages	176,421	-	-	-	-	-	-	-	-	-	-	176,421
Leases	9,586	-	14,244	2,451	8	-	5,227	213	304	1,475	228	33,736
Other loans	38,144	-	56,151	11,926	3,601	-	36,837	9,775	4,704	62,913	66,696	290,747
Off-balance sheet items:												
Financial guarantees	1,299	-	2,559	2,343	-	1,500	1,298	24	11	48	492	9,574
Undrawn loan commitments	-	-	392	879	9,069	-	3,880	-	-	4,995	186	19,401
Undrawn overdraft	9,646	-	5,634	1,013	202	1,102	2,125	195	1,704	726	1,324	23,671
Credit card commitments	22,594	-	3,267	408	12	91	800	124	887	160	144	28,487
Total maximum credit exposure	288,593	180,083	93,427	23,283	13,475	53,565	54,667	11,659	9,612	73,031	71,572	872,967

Amounts are in ISK million

45. Credit exposure covered by collateral

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. In the case of corporate entities the Bank takes a charge over assets such as real estate, fishing vessels, cash and securities and as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured. Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

In some cases the Bank uses guarantees as a credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in maximum exposure to credit risk. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation. Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Bank's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates.

An estimate of the collateral held by the Bank against credit exposure is shown below:

At 30 September 2014

	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	2,758	-	-	2,758
Loans and commitments to customers:	368,271	68,893	6,613	33,293	21,332	498,402
Individuals	211,839	31	534	9,545	8	221,957
Commerce and services	37,038	247	502	14,988	5,931	58,706
Construction	10,916	110	130	2,485	4,194	17,835
Energy	2,886	-	455	1	113	3,455
Financial services	39	-	143	1	-	183
Industrial and transportation	16,674	-	95	5,649	7,085	29,503
Investment companies	7,760	-	3,897	75	2,406	14,138
Public sector and non-profit organisations	1,599	-	11	189	-	1,799
Real estate	74,290	-	564	149	21	75,024
Seafood	5,230	68,505	282	211	1,574	75,802
Total	368,271	68,893	9,371	33,293	21,332	501,160

At 31 December 2013

	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	1,820	-	-	1,820
Loans and commitments to customers:	321,247	59,488	6,895	31,053	14,603	433,286
Individuals	202,593	26	1,410	8,791	5	212,825
Commerce and services	30,764	217	1,098	12,998	5,193	50,270
Construction	8,912	143	84	3,961	1,418	14,518
Energy	3,242	-	87	-	122	3,451
Financial services	4	-	-	-	-	4
Industrial and transportation	18,161	-	98	4,682	5,029	27,970
Investment companies	4,108	-	2,783	44	55	6,990
Public sector and non-profit organisations	1,438	3	3	223	-	1,667
Real estate	47,377	25	445	155	21	48,023
Seafood	4,648	59,074	887	199	2,760	67,568
Total	321,247	59,488	8,715	31,053	14,603	435,106

For the nine months ended 30 September 2014 37 Amounts are in ISK million

46. Credit quality of financial assets

Loans are classified as impaired loans if contractual cash payments are not expected to be fulfilled and if financial restructuring of the obligor is expected to lead to a loss on that particular loan. In most cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio.

The full carrying amount of all loans which give rise to individual impairment is included in impaired loans, even if parts are covered by collateral. The collective impairment has not been subtracted from the carrying amount here.

At 30 September 2014

	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	135,138	-	-	135,138
Derivatives	4,199	-	-	4,199
Bonds and debt instruments	86,007	-	-	86,007
Loans to credit institutions	41,720	-	-	41,720
Loans to customers:	553,618	34,113	23,452	611,183
Individuals	230,496	21,789	8,219	260,504
Commerce and services	66,420	4,815	7,106	78,341
Construction	15,598	973	1,555	18,126
Energy	3,636	-	-	3,636
Financial services	34	38	-	72
Industrial and transportation	58,022	1,396	1,202	60,620
Investment companies	16,084	1,027	45	17,156
Public sector and non-profit organisations	11,329	33	12	11,374
Real estate	75,671	2,685	2,338	80,694
Seafood	76,328	1,357	2,975	80,660
Total	820,682	34,113	23,452	878,247

At 31 December 2013

	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	111,779	-	-	111,779
Derivatives	2,368	-	-	2,368
Bonds and debt instruments	75,186	-	-	75,186
Loans to credit institutions	44,078	-	-	44,078
Loans to customers:	496,705	34,618	27,100	558,423
Individuals	222,791	23,944	8,309	255,044
Commerce and services	71,177	3,759	6,586	81,522
Construction	16,780	1,005	855	18,640
Energy	3,614	-	-	3,614
Financial services	34	-	-	34
Industrial and transportation	43,175	1,318	1,940	46,433
Investment companies	9,293	506	507	10,306
Public sector and non-profit organisations	6,818	52	24	6,894
Real estate	58,694	2,356	5,597	66,647
Seafood	64,329	1,678	3,282	69,289
Total	730,116	34,618	27,100	791,834

For the nine months ended 30 September 2014 38 Amounts are in ISK million

47. Neither past due nor impaired loans

The Bank uses internal rating models to assess the default probability of corporate and retail customers. The models assign each customer to one of ten risk classes. One risk class is for customers in default (risk class 10), and nine risk classes are for performing customers (risk classes 1-9). Risk classes are assigned on customer level and not facility level.

The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its management, market position and industry sector.

For retail customers the Bank uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Bank of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits, and demographic variables to assess the probability that a customer will default on any of his obligations within 12 months of the rating assessment.

The table below shows loans that are neither past due nor impaired aggregated in five customer groups based on the default probability. Group 1-4 represents low risk, group 5-6 moderate risk, group 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers in default.

Note that the same customer can have loans that are more than 90 days past due or impaired, and at the same time other loans that are neither past due nor impaired. Those customers will be in risk class 10 and their loans that are neither past due nor impaired are included in the table below.

At 30 September 2014

	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers							
Individuals	9,391	81,831	87,630	42,749	5,713	3,182	230,496
Commerce and services	12,900	24,644	23,697	3,168	1,186	825	66,420
Construction	-	6,297	8,136	650	510	5	15,598
Energy	2,496	1,113	27	-	-	-	3,636
Financial services	14	5	12	2	-	1	34
Industrial and transportation	23,805	23,898	8,695	956	526	142	58,022
Investment companies	663	9,551	4,206	900	507	257	16,084
Public sector and non-profit organisations	6,365	3,848	903	162	-	51	11,329
Real estate	4,060	44,170	12,681	1,956	10,768	2,036	75,671
Seafood	36,343	31,575	6,465	707	1,051	187	76,328
Total	96,037	226,932	152,452	51,250	20,261	6,686	553,618

At 31 December 2013

	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers							
Individuals	8,388	77,267	82,203	44,295	7,609	3,029	222,791
Commerce and services	14,544	20,982	27,505	2,751	2,768	2,627	71,177
Construction	-	4,279	10,864	606	601	430	16,780
Energy	2,150	1,445	19	-	-	-	3,614
Financial services	6	1	19	5	-	3	34
Industrial and transportation	13,909	16,431	8,796	3,278	410	351	43,175
Investment companies	837	3,220	3,654	924	142	516	9,293
Public sector and non-profit organisations	1,756	3,060	1,804	93	3	102	6,818
Real estate	127	35,019	11,140	1,470	8,093	2,845	58,694
Seafood	21,363	29,347	11,719	300	1,339	261	64,329
Total	63,080	191,051	157,723	53,722	20,965	10,164	496,705

For the nine months ended 30 September 2014 39 Amounts are in ISK million

48. Restructuring and forbearance

Restructuring of customers' debt has been one of the Bank's main tasks since October 2008. This has been a challenge as such a large part of customers have needed forbearance measures. Legal issues, political environment and the general economy have contributed in ways of uncertainty and complications. The Bank has set in place processes and resources to take on this task. The Bank's management team is kept well informed on the status of restructuring on a regular basis.

The Bank has offered several debt relief measures and restructuring frameworks for its customers since its establishment. These restructuring frameworks include principal adjustment and recalculation of currency linked loans, debt adjustment for companies and individuals, 110% adjustment of mortgages, write-offs and tailor made solutions in complicated cases where general solutions do not suffice.

Other forbearance measures which the Bank can make available include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In many cases these measures are precursors to the more formal restructuring process.

49. Past due but not impaired loans

Past due but not impaired loans are loans where contractual interest or principal payments have passed due date without the obligor making full payment, but where specific impairment is not appropriate. The reason is usually that contractual payments are eventually expected to be fulfilled or these loans are expected to be restructured without any loss to the Bank. In some cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio. In other cases, there is sufficient collateral.

Amounts reported as loans past due refer to the total loan exposure and not only the payment or sum of payments that are past due. Payments three days in arrears or less are not considered to be past due and the corresponding loans are therefore omitted here. Past due but not impaired loans are as follows:

At 30 September 2014

	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:					
Individuals	9,051	3,857	553	8,328	21,789
Commerce and services	3,081	727	186	821	4,815
Construction	364	103	61	445	973
Energy	-	-	-	-	-
Financial services	38	-	-	-	38
Industrial and transportation	671	189	65	471	1,396
Investment companies	709	62	19	237	1,027
Public sector and non-profit organisations	23	3	1	6	33
Real estate	1,248	675	183	579	2,685
Seafood	99	24	9	1,225	1,357
Total	15,284	5,640	1,077	12,112	34,113

At 31 December 2013

	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:					
Individuals	8,615	4,181	786	10,362	23,944
Commerce and services	1,349	1,000	335	1,075	3,759
Construction	330	279	24	372	1,005
Energy	-	-	-	-	-
Financial services	-	-	-	-	-
Industrial and transportation	375	203	45	695	1,318
Investment companies	181	35	137	153	506
Public sector and non-profit organisations	38	6	1	7	52
Real estate	1,040	460	109	747	2,356
Seafood	790	107	78	703	1,678
Total	12,718	6,271	1,515	14,114	34,618

For the nine months ended 30 September 2014 40 Amounts are in ISK million

50. Large exposure disclosure

When the Bank's total exposure to a group of connected clients is 10% or higher of the Bank's capital base it is considered a large exposure. Both on-balance sheet and off-balance sheet items from all types of financial instruments are included in the exposure as defined by FME rules 625/2013. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) of law 161/2002 on Financial Undertakings, where groups of connected clients are defined. According to the law the official capital base shall be based on audited or reviewed own funds. Since the interim accounts for the third quarter of the year are not audited, the official capital is based on reviewed own fund items at 30 June 2014.

The exposure is evaluated both gross and net of credit risk mitigating effects eligible according to the FME rules. Net of mitigating effects, the Bank has currently no large exposure above 10% of its capital base. In particular, no large exposure is above the maximum 25% single large exposure limit set by the law.

The following tables show the Bank's large exposures as a percentage of the Bank's capital base, gross and net of eligible credit risk mitigating effects. Note that group references might change between reporting periods, i.e. Group 1 might not be the same group in the two tables.

		30.9.2014
Client groups	Gross	Net
Group 1	87%	0%

		31.12.2013
Client groups	Gross	Net
Group 1	78%	0%

Amounts are in ISK million

Liquidity Risk

51. The Bank defines liquidity risk as the risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

Liquidity risk management

The Bank's main source of funding is customer deposits. The Bank's Treasury is responsible for the Bank's funding and liquidity management within the limits approved by the Board and the Asset and Liability Committee. The Interbank desk manages the Bank's intraday liquidity.

Risk management is responsible for measuring, monitoring and reporting on the Bank's liquidity position.

The Bank's liquidity risk policy assumes that the Bank has at all times sufficient liquidity to meet liabilities and other obligations over the next twelve months.

The tables below show the contractual payments of principal and interest for the Bank´s financial liabilities. Thus, the total figures for each liability class are higher than the respective balance sheet amount. Cash flows for payments of unknown nature, such as for floating rate, CPI linked or foreign currency denominated instruments, are based on internal yield curves and forecasts.

For dated financial liabilities the amounts are grouped into maturity buckets according to contractual maturities of principal and estimated contractual payments of interest. For demand deposits or other non-dated liabilities, the figures are grouped according to the first possible required payment date.

In the table below the total amount for loans to customers is shown before latent impairment allowance and is therefore higher than the total amount shown in the financial statement.

Maturity analysis 30 September 2014

Financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	-	-	3,646	724	1,307	-	5,677
Deposits from Central Bank	35	-	-	-	-	-	35
Deposits from credit institutions	18,692	5,397	303	-	-	-	24,392
Deposits from customers	366,411	78,849	56,666	19,769	28,128	-	549,823
Debt issued and other borrowed funds	2	8,592	7,901	79,797	13,504	-	109,796
Subordinated loans	-	-	777	5,659	22,003	-	28,439
Other financial liabilities	41,193	10,633	3,746	2,524	-	-	58,096
Total financial liabilities	426,333	103,471	73,039	108,473	64,942	-	776,258

Off-balance sheet liabilities show the amount of contractual obligations that the Bank has taken towards customers, either by committing to lend out money in the future or as third party guarantees. The amounts shown reflect the maximum amount, not taking into account the Bank's ability to reduce overdraft or credit card limits before the current undrawn amount is fully utilised by the customer. These obligations all fall into the first time bucket since contractually, on a case-by-case basis, the Bank could be required to fulfil these obligations instantaneously.

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	9,306	-	-	-	-	-	9,306
Undrawn loan commitments	32,804	-	-	-	-	-	32,804
Undrawn overdrafts	28,195	-	-	-	-	-	28,195
Credit card commitments	30,254	-	-	-	-	-	30,254
Total	100,559	-	-	-	-	-	100,559
Total non-derivative financial liabilities and off-balance sheet liabilities	526,892	103,471	73,039	108,473	64,942	-	876,817

The table below shows the contractual cash flow of the Bank's derivative liabilities, i.e. derivatives that have a negative carrying amount at the date of reporting. Derivatives with a positive carrying amount are detailed separately. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

For the nine months ended 30 September 2014 42 Amounts are in ISK million

51. Cont'd

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	6,115	6,524	66,788	-	-	79,427
Outflow	-	(6,002)	(6,794)	(70,123)	-	-	(82,919)
Total	-	113	(270)	(3,335)	-	-	(3,492)
Net settled derivatives	-	(50)	-	-	-	-	(50)
Total	-	63	(270)	(3,335)	-	-	(3,542)

Maturity classification of assets is based on contractual maturity. For loans that were acquired at a deep discount and have not yet been restructured, the contractual amount is scaled to reflect the carrying amount of the claim. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity dates while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	25,196	109,942	-	-	-	-	135,138
Bonds and debt instruments	370	21,039	22,540	34,647	7,411	-	86,007
Shares and equity instruments	-	-	-	-	-	10,884	10,884
Loans to credit institutions	25,399	16,180	141	-	-	-	41,720
Loans to customers	5,610	76,214	50,512	177,742	298,250	-	608,328
Other financial assets	8,640	1,069	219	182	5	3,756	13,871
Total financial assets	65,215	224,444	73,412	212,571	305,666	14,640	895,948
Derivative financial assets							
Gross settled derivatives							
Inflow	-	7,649	4,145	32,852	-	-	44,646
Outflow	-	(7,399)	(3,470)	(32,139)	-	-	(43,008)
Total	-	250	675	713	-	-	1,638
Net settled derivatives	-	347	-	-	-	-	347
Total	-	597	675	713	-	-	1,985

The tables below show the comparative amounts for financial assets and liabilities at year-end 2013.

Maturity analysis 31 December 2013

Financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	9,462	-	-	-	-	-	9,462
Deposits from Central Bank	63	-	-	-	-	-	63
Deposits from credit institutions	26,804	2,457	413	-	-	-	29,674
Deposits from customers	346,352	47,265	52,685	29,918	29,429	-	505,649
Debt issued and other borrowed funds	2	6,765	15,988	52,993	28,397	-	104,145
Subordinated loans	-	-	749	6,869	24,919	-	32,537
Other financial liabilities	33,576	4,874	9,196	-	74	-	47,720
Total financial liabilities	416,259	61,361	79,031	89,780	82,819	-	729,250

For the nine months ended 30 September 2014 43 Amounts are in ISK million

51. Cont'd

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	9,574	-	-	-	-	-	9,574
Undrawn loan commitments	19,401	-	-	-	-	-	19,401
Undrawn overdrafts	23,671	-	-	-	-	-	23,671
Credit card commitments	28,487	-	-	-	-	-	28,487
Total	81,133	-	-	-	-	-	81,133
Total non-derivative financial liabilities and off-balance sheet liabilities	497,392	61,361	79,031	89,780	82,819	-	810,383

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	3,865	8,742	65,955	-	-	78,562
Outflow	-	(3,906)	(8,321)	(71,328)	-	-	(83,555)
Total	-	(41)	421	(5,373)	-	-	(4,993)
Net settled derivatives	-	(195)	-	-	-	-	(195)
Total	-	(236)	421	(5,373)	-	-	(5,188)

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central bank	12,695	99,084	-	-	-	-	111,779
Bonds and debt instruments	5,503	35,250	67	26	31,805	2,535	75,186
Shares and equity instruments	46	-	9	344	-	8,986	9,385
Loans to credit institutions	29,420	14,497	161	-	-	-	44,078
Loans to customers	932	75,481	42,852	150,591	289,067	-	558,923
Other financial assets	7,102	1,541	102	1,658	-	3,169	13,572
Total financial assets	55,698	225,853	43,191	152,619	320,872	14,690	812,923

Derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	4,793	3,732	10,508	2,523	-	21,556
Outflow	-	(4,605)	(3,584)	(10,265)	(2,813)	-	(21,267)
Total	-	188	148	243	(290)	-	289
Net settled derivatives	-	58	-	-	-	-	58
Total	-	246	148	243	(290)	-	347

As a part of managing liquidity risk, the Bank holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Bank's liquidity back-up at the end of September 2014 and year-end 2013.

Composition and amount of liquidity back-up	30.9.2014	31.12.2013
Cash and balances with Central Bank	135,138	111,779
Domestic bonds eligible as collateral against borrowing at Central Bank	28,009	20,873
Foreign government bonds	43,959	34,618
Short-term placements with credit institutions	39,246	41,192
Composition and amount of liquidity back-up	246,352	208,462

For the nine months ended 30 September 2014 44 Amounts are in ISK million

Market risk

52. The Bank defines market risk as the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices, commodity prices and foreign exchange rates.

Market risk management
The Bank's market risk appetite is determined by the Board of Directors. The Asset and Liability Committee (ALCO) decides on limits for portfolios and products in accordance with the market risk policy approved by the Board. Risk management is responsible for monitoring and reporting on the Bank's overall market risk positions and compliance to limits. The objective of market risk management is to manage and control market risk exposures within acceptable parameters.

The Bank separates exposures to market risk into trading book and banking book (non-trading portfolios). The Bank's primary sources of market risk in the trading portfolio are shares, debt instruments and foreign currency positions. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. Market risk in the banking book is mainly due to mismatches in interest rate terms and denomination currency of assets and liabilities. These mismatches are reported to management and are subject to regulatory and internal limits.

Interest rate risk

53. Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates.

The Bank uses sensitivity measures like Basis Point Value (BPV) to measure and manage risk arising from its fixed income exposures. The BPV measures the effect of a 0.01 percentage point upward parallel shift in the yield curve on the fair value of these exposures.

54. Interest rate risk in trading portfolios

The fixed income trading unit invests mainly in government bonds and bonds issued by the Housing Financing Fund (HFF), which are guaranteed by the Icelandic government. These positions can include short positions. Government bonds are either indexed to the Icelandic Consumer Price Index (CPI) or non-indexed, with duration up to 10 years. HFF bonds are CPI linked and have duration up to 13 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day. In addition to BPV limits short and long positions in each instrument are subject to separate limits. Risk Management monitors these limits and reports all breaches to ALCO.

Note that in the table below the total market value of long and short positions may not be exactly the same as reported in Note 7. The reason for this difference is that Note 7 sums up the net positions in each security while the table below ignores both netting of long and short positions in specific securities between different portfolios and hedge positions against derivative contracts.

Trading bonds and debt instruments, long positions	30.9.2014			31.12.2013		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	3,863	7.14	(2.76)	3,282	7.41	(2.43)
Non-indexed	44,991	0.30	(1.33)	35,848	0.32	(1.13)
Total	48,854	0.84	(4.09)	39,130	0.91	(3.56)

Trading bonds and debt instruments, short positions	30.9.2014			31.12.2013		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	219	5.83	0.13	291	6.39	0.19
Non-indexed	2,022	4.53	0.91	2,878	2.23	0.64
Total	2,241	4.66	1.04	3,169	2.61	0.83
Net position of trading bonds and debt instruments	46,613	0.65	(3.05)	35,961	0.76	(2.73)

For the nine months ended 30 September 2014 45 Amounts are in ISK million

55. Interest rate risk in the banking book

Interest rate risk in the banking book arises from the Bank's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as interest rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Bank holds a government bond designated at fair value amounting to ISK 30.6 billion (31 December 2013: ISK 30.8 billion). The bond pays floating rates and carries relatively low interest rate risk.

The Bank uses traditional measures for assessing the sensitivity of the Bank's financial assets, financial liabilities and earnings to changes in the underlying interest rates.

In the table below the total amount for loans to customers is shown before latent impairment allowance is subtracted and is therefore not the same as the total amount shown in the financial statement. Loans with specific impairment have been placed in the category 0-3 months since such loans bear no interest rate risk until possibly after debt restructuring.

Banking book interest rate adjustment periods on 30 September 2014

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	132,492	-	-	-	-	-	132,492
Bonds and debt instruments	30,503	1,250	-	1,296	274	359	33,682
Loans to credit institutions	41,552	168	-	-	-	-	41,720
Loans to customers	459,176	53,737	29,093	56,270	2,033	10,872	611,181
Total assets	663,723	55,155	29,093	57,566	2,307	11,231	819,075
Off-balance sheet items..	65,756	2,001	20,991	1,958	-	-	90,706
Liabilities							
Short positions	-	3,055	-	-	-	-	3,055
Deposits from Central Bank	35	-	-	-	-	-	35
Deposits from credit institutions	24,079	291	-	-	-	-	24,370
Deposits from customers	520,968	4,661	1,028	1,955	7,492	-	536,104
Debt issued and other borrowed funds	10,172	15,027	19,201	41,493	11,821	-	97,714
Subordinated loans	-	21,089	-	-	-	-	21,089
Total liabilities	555,254	44,123	20,229	43,448	19,313	-	682,367
Off-balance sheet items	70,227	11,105	4,757	9,342	-	-	95,431
Net interest gap on 30 September 2014	103,998	1,928	25,098	6,734	(17,006)	11,231	131,983

For the nine months ended 30 September 2014 46 Amounts are in ISK million

55. Cont'd

Banking book interest rate adjustment periods on 31 December 2013

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank......................................	111,779	-	-	-	-	-	111,779
Bonds and debt instruments	31,302	632	20	1,275	154	493	33,876
Loans to credit institutions	43,917	161	-	-	-	-	44,078
Loans to customers	397,719	46,565	57,552	38,803	1,586	12,516	554,741
Total assets	584,717	47,358	57,572	40,078	1,740	13,009	744,474
Off-balance sheet items	19,191	30,980	1,001	4,733	-	-	55,905
Liabilities							
Short positions	2,439	399	-	832	-	-	3,670
Deposits from Central Bank	63	-	-	-	-	-	63
Deposits from credit institutions	29,225	401	-	-	-	-	29,626
Deposits from customers	476,312	2,944	-	2,885	7,190	-	489,331
Debt issued and other borrowed funds	20,518	4,369	2,450	45,263	7,208	9,386	89,194
Subordinated loans	21,890	-	-	-	-	-	21,890
Total liabilities	550,447	8,113	2,450	48,980	14,398	9,386	633,774
Off-balance sheet items	20,046	23,638	5,338	8,195	-	-	57,217
Net interest gap on 31 December 2013	33,415	46,587	50,785	(12,364)	(12,658)	3,623	109,388

Amounts are in ISK million

Currency risk

56. Currency risk is the risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or due to a mismatch in the currency composition of assets or liabilities.

The analysis of the Bank's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements. The tables below summarise the Bank's exposure to currency risk at 30 September 2014 and 31 December 2013, based on contractual currencies and off-balance sheet items, but excluding assets categorised as held-for-sale.

Currency analysis 30 September 2014

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank......................	344	198	83	39	9	244	917
Bonds and debt instruments....................................	25,967	8,909	1,962	-	-	8,150	44,988
Shares and equity instruments................................	280	225	0	1	-	-	506
Loans to credit institutions.......................................	12,045	17,358	2,022	1,737	535	4,549	38,246
Loans to customers...	62,730	23,061	5,382	9,340	8,265	10,007	118,785
Other assets..	672	1,911	188	0	5	110	2,886
Total assets	102,038	51,662	9,637	11,117	8,814	23,060	206,328
Liabilities							
Deposits from credit institutions	167	14	12	0	14	1	208
Deposits from customers	37,780	25,955	6,204	2,232	1,630	8,895	82,696
Debt issued and other borrowed funds	15,273	-	-	-	-	13,426	28,699
Subordinated loans	21,089	-	-	-	-	-	21,089
Other liabilities...	6,007	5,926	882	1	79	478	13,373
Total liabilities	80,316	31,895	7,098	2,233	1,723	22,800	146,065
On-balance sheet imbalance	21,722	19,767	2,539	8,884	7,091	260	60,263
Off-balance sheet items							
Off-balance sheet assets	23,359	17,916	823	460	54	11,869	54,481
Off-balance sheet liabilities	36,759	34,610	893	8,859	6,714	4,156	91,991
Net off-balance sheet items	(13,400)	(16,694)	(70)	(8,399)	(6,660)	7,713	(37,510)
Net currency imbalance on 30 September 2014..	8,322	3,073	2,469	485	431	7,973	22,753

Amounts are in ISK million

56. Cont'd

Currency analysis 31 December 2013

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank	326	194	108	29	10	252	919
Bonds and debt instruments	8,757	14,779	1,902	-	-	10,206	35,644
Shares and equity instruments	377	261	11	1	-	-	650
Loans to credit institutions	5,494	18,566	817	2,967	267	13,869	41,980
Loans to customers	56,060	10,813	4,661	6,486	6,834	4,665	89,519
Investments in associates	-	-	-	-	-	-	-
Other assets	4,261	1,801	152	-	33	66	6,313
Total assets	75,275	46,414	7,651	9,483	7,144	29,058	175,025
Liabilities							
Deposits from credit institutions	189	504	-	-	13	-	706
Deposits from customers	38,627	28,978	5,153	1,419	876	9,483	84,536
Debt issued and other borrowed funds	-	-	-	-	-	8,937	8,937
Subordinated loans	21,890	-	-	-	-	-	21,890
Other liabilities	1,911	5,839	875	2	33	156	8,816
Total liabilities	62,617	35,321	6,028	1,421	922	18,576	124,885
On-balance sheet imbalance	12,658	11,093	1,623	8,062	6,222	10,482	50,140
Off-balance sheet items							
Off-balance sheet assets	12,838	17,024	533	-	519	613	31,527
Off-balance sheet liabilities	17,022	24,558	437	7,582	4,651	3,689	57,939
Net off-balance sheet items	(4,184)	(7,534)	96	(7,582)	(4,132)	(3,076)	(26,412)
Net currency imbalance on 31 December 2013...	8,474	3,559	1,719	480	2,090	7,406	23,728

Derivatives

57. The Bank uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. The Bank carries relatively low indirect exposure due to margin trading with clients and the Bank holds collaterals for possible losses. Other derivatives in the Bank held for trading or for other purposes are insignificant.

Inflation risk

58. The Bank is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 30 September 2014 the CPI gap amounted to ISK 38.1 billion (31 December 2013: ISK 6.4 billion). Thus, a 1% increase in the index would lead to CPI-indexed assets increasing by ISK 381 million more than CPI-indexed liabilities and a 1% decrease would lead to CPI-indexed liabilities increasing by ISK 381 million more than CPI-indexed assets, other risk factors held constant.

Amounts are in ISK million

Capital management

59. Risk exposure and capital base

The table below shows the capital base, risk weighted assets and the resulting capital ratios of the Bank at 30 September 2014 and 31 December 2013. In addition, the table shows the official capital ratios based on reviewed own fund items at 30 June 2014.

According to the Act on Financial Undertakings no. 161/2002 the official capital ratio of the Bank shall be based on audited or reviewd own fund items. Since the interim accounts for the third quarter are not audited, the official capital ratio is based on reviewd own fund items at 30 June 2014 and risk weighted assets at 30 September 2014. The official capital ratio at 30 September 2014 was 28.9% and the Tier 1 ratio was 25.8%.

As required in the Basel II rules, the Bank's Board of Directors sets a minimum capital target for the Bank. The Board has approved a minimum capital target for the Bank to be 18% of RWA. The target is based on the Bank's internal capital adequacy assessment (ICAAP) and the views expressed by the regulator through the latest SREP results. The capital target is intended to support the Bank's business strategy and takes into account changes or uncertainties in the operating environment. Unlike the 8% regulatory minimum, the Bank's capital target can change over time reflecting changes in the Bank's risk profile, business strategy and external environment. Thus, falling below the capital target does not impose any direct regulatory actions but the Bank's dividend payments and remuneration can be impacted.

The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach.

	30.9.2014	31.12.2013
Tier 1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,369	2,471
Retained earnings	112,374	98,548
Non-controlling interests	1,574	1,299
Tax assets	(694)	(1,275)
Intangible assets	(339)	(299)
Other regulatory adjustments	(160)	(159)
Total Tier 1 capital	180,124	165,585
Tier 2 capital		
Other regulatory adjustments	(160)	(160)
Qualifying subordinated liabilities	21,089	21,890
Total regulatory capital	201,053	187,315
Risk weighted assets		
- due to credit risk	573,009	551,938
- due to market risk:	31,879	28,849
Market risk, trading book	9,122	5,105
Currency risk foreign exchange	22,757	23,744
- due to operational risk	78,970	78,970
Total risk weighted assets	683,858	659,757
Capital ratios		
Tier 1 ratio	26.3%	25.1%
Total capital ratio	29.4%	28.4%
Official Tier 1 ratio	25.8%	25.1%
Official capital ratio	28.9%	28.4%

Amounts are in ISK million