7 June 2021

Prospectus

Íslandsbanki hf.

(Íslandsbanki hf., a limited company established under the laws of the Republic of Iceland)

Admission to listing and trading on Nasdaq Iceland of ordinary shares
Public offering in Iceland of up to 636,363,630 ordinary shares

This is the initial offering of up to 636,363,630 ordinary shares, in the form of existing Shares (the "**Existing Offer Shares**") together with the Over-Allotment Shares (as defined below) (the "**Offer Shares**") of Íslandsbanki hf., (the "**Bank**"), a limited company established under the laws of the Republic of Iceland ("**Iceland**"), by Icelandic State Financial Investments on behalf of the Treasury of Iceland (the "**Selling Shareholder**"). The term "**Group**" refers to the Bank and its consolidated subsidiaries, unless the context otherwise requires. Assuming no exercise of the Over-Allotment Option (as defined below), the Offer Shares will constitute up to 31.8% of the issued and outstanding ordinary shares, each with a par value of Icelandic króna ("**Icelandic Króna**" or "**ISK**") 5.00. If the Over-Allotment Option is fully exercised, the Offer Shares will constitute up to 35.0% of the issued and outstanding Shares.

The offering of the Offer Shares (the "**Offering**") consists of (a) a public offering in Iceland of the Offer Shares to institutional and retail investors and (ii) a private placement to certain institutional investors in various other jurisdictions. The Offer Shares are being offered (i) within the United States of America (the "**United States**" or "**U.S.**"), to persons reasonably believed to be "qualified institutional buyers" ("**QIBs**") as defined in, and in reliance on, Rule 144A ("**Rule 144A**") under the U.S. Securities Act of 1933, as amended (the "**U.S. Securities Act**"), or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act and applicable state and other securities laws of the United States and (b) outside the United States, where all offers and sales of the Offer Shares will be made in compliance with Regulation S under the U.S. Securities Act ("**Regulation S**").

Prior to the Offering, there has been no public market for the Offer Shares. Application has been made to list and admit all of the Shares to trading under the symbol "ISB" on Nasdaq Iceland ("**Nasdaq Iceland**"). Subject to acceleration or extension of the timetable for the Offering, admission to listing and unconditional trading of the Shares on Nasdaq Iceland and is expected to occur on or about 22 June 2021.

The price range of the Offer Shares (the "Offer Price Range") is ISK 71 to ISK 79 per Existing Offer Share.

The price at which the Offer Shares will be sold (the "**Offer Price**") is expected to be between ISK 71 and ISK 79 per Existing Offer Share. The Offer Price will be set in ISK. The Offer Price and the exact number of the Offer Shares to be sold is expected to be announced on or about 15 June 2021. Payment for the Offer Shares is expected to be due no later than 21 June 2021, and delivery of the Offer Shares ("**Settlement**") is expected to take place on or about 22 June 2021 (the "**Settlement Date**"). If Settlement does not take place on the Settlement Date as planned or at all, the Offering may be withdrawn, in which case all subscriptions for the Offer Shares will be disregarded, any allotments made will be deemed not to have been made and any subscription payments made will be returned without interest or other compensation. None of the Bank, the Selling Shareholder, the Financial Advisors (as defined below), the Managers (as defined below) or Nasdaq Iceland accept responsibility or liability towards any person as a result of the withdrawal of the Offering or the related annulment of any transaction in the Offer Shares.

Each of (i) funds managed and advised by Capital World Investors; (ii) RWC Asset Management LLP; (iii) Gildi-lífeyrissjóður; and (iv) Lífeyrissjóður verzlunarmanna (the "**Cornerstone Investors**") has committed to acquire at the Offer Price (and at any such price throughout the Offer Price Range set forth above) 76,923,077, 30,769,231, 46,153,846 and 46,153,846 Offer Shares, respectively. These commitments are subject to certain conditions as described in "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

INVESTING IN THE OFFER SHARES INVOLVES RISKS. SEE "*RISK FACTORS*" BEGINNING ON PAGE 12 OF THIS PROSPECTUS FOR A DESCRIPTION OF CERTAIN RISKS THAT SHOULD BE CAREFULLY CONSIDERED BEFORE INVESTING IN THE OFFER SHARES.

The Offer Shares will be delivered in book-entry form through the facilities of Nasdaq CSD Iceland ("**Nasdaq CSD Iceland**"). The Selling Shareholder has granted the Managers an option (the "**Over-Allotment Option**"), exercisable in whole or in part by the Joint Global Coordinators (as defined below) on behalf of the Managers, for 30 calendar days after the Settlement Date, pursuant to which the Managers may require the Selling Shareholder to sell at the Offer Price up to 63,636,363 additional Shares comprising up to 10% of the total number of Existing Offer Shares sold in the Offering (the "**Over-Allotment Shares**"), to cover short positions resulting from any over-allotments made in connection with the Offering or stabilisation transactions, if any. In connection with the Offering and to the degree permitted by applicable law, Landsbankinn hf., as stabilising manager (the "**Stabilising Manager**"), or any of its agents, on behalf of the Managers, may (but will be under no obligation to) engage in transactions that stabilise, maintain or otherwise affect the price of the Shares for up to 30 days from the commencement of trading on Nasdaq Iceland.

Citi, Íslandsbanki and J.P. Morgan are acting as joint global coordinators and joint bookrunners (in such and any other capacity, the "**Joint Global Coordinators**"), Barclays Bank Ireland PLC, HSBC Continental Europe, Fossar Markaðir hf. and Landsbankinn hf. are acting as joint bookrunners for the Offering (together with the Joint Global Coordinators, the "**Joint Bookrunners**"), Arion banki hf. and Kvika banki hf. are acting as joint lead managers (the **Joint Lead Managers**"), and Arctica Finance hf., Íslenskir fjárfestar hf. and Íslensk verðbréf hf. are acting as Co-Lead Managers (the "**Co-Lead Managers**" and, together with the Joint Bookrunners and the Joint Lead Managers, the "**Managers**"). In connection with the Offering, STJ Advisors Group Limited ("**STJ**") is acting as financial advisor to the Selling Shareholder, and ABN AMRO Bank N.V. ("**ABN AMRO**") is acting as financial advisor to the Bank, and STJ and ABN AMRO are hereinafter jointly referred to as the "**Financial Advisors**".

The Offer Shares have not been, and will not be, registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and may not be offered or sold within the United States unless the Offer Shares are registered under the U.S. Securities Act or pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act. There will be no public offer of the Offer Shares in the United States. Prospective purchasers are hereby notified that the Bank, the Selling Shareholder and any other sellers of the Offer Shares are relying on an exemption from the registration requirements of Section 5 of the U.S. Securities Act, which may include Rule 144A or Regulation S.

This document comprises a prospectus for the purposes of Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 (as amended) (the "**Prospectus Regulation**"), as implemented into Icelandic law through Act No. 14/2020 on Prospectus for Public Offering or Admission to Trading on a Regulated Market (the "**Prospectus Act**") (this "**Prospectus**"). The level of disclosure complies with Annexes 1 (registration document for equity securities) and 11 (Securities note for equity securities or of units issued by collective investment undertakings of the closed-end type) to the Commission Delegated Regulation (EU) 2019/980 of 14 March 2019 (the "**Commission Delegated Regulation (EU) 2019/980**"), supplementing the Prospectus Regulation. This Prospectus has been approved by the Financial Supervisory Authority (the "**FSA**") of the Central Bank of Iceland (*Seðlabanki Íslands*) (the **"Central Bank of Iceland"**) as competent authority under Regulation (EU) 2017/1129. The FSA only approves this Prospectus as meeting the standard of completeness, comprehensibility and consistency imposed by the Prospectus Regulation. Such approval of the FSA shall not be considered as an endorsement to the Bank or the quality of the Offer Shares. Investors shall make their own assessment as to the suitability of investing in the Offer Shares. This Prospectus is available at the FSA website (www.fme.is) and the Bank's website (www.islandsbanki.is) and will remain publicly available on the Bank's website for at least 10 years following the date hereof. Neither the delivery of this Prospectus nor any sale made hereunder shall, under any circumstances, create any implication that there has been no change in the affairs of the Bank since the date hereof or that the information contained herein is correct as at any time subsequent to such date. Information in this Prospectus is based on circumstances and facts on the date it is signed, unless otherwise specified, and is subject to change without notice. Unless otherwise explicitly stated, the source of information included in this Prospectus is the Bank.

Joint Global Coordinators and Joint Bookrunners

Citigroup **Íslandsbanki** **J.P. Morgan**

Joint Bookrunners

Barclays **Fossar Markets**

HSBC **Landsbankinn**

Joint Lead Managers

Arion Bank **Kvika**

Co-Lead Managers

Arctica Finance **Icelandic Investors** **ÍV**

This Prospectus is dated 7 June 2021

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SUMMARY

This summary is made in accordance with Article 7 of Regulation (EU) 2017/1129 of the European Parliament and of the Council (the "**Prospectus Regulation**") and Article 2 of Commission Delegated Regulation (EU) 2019/979 supplementing the Prospectus Regulation. This summary is comprised of four parts a) Introduction and warnings b) Key information about the Bank c) Key information about the securities and d) Key information about the offering.

A. Introduction and Warnings

This summary should be read as an introduction to the prospectus of Íslandsbanki hf. (the "**Bank**"), of which this summary is a part, dated 7 June 2021 (the "**Prospectus**"). This summary should be read as an introduction to the Prospectus. Any decision to invest in the securities should be based on a consideration of the Prospectus as a whole by the investor. An investment in the Bank's securities involves inherent risk and an investor investing in the securities could lose all or part of its investment.

Where a claim relating to the information contained in the Prospectus is brought before a court, the plaintiff investor might, under national law, bear the costs of translating the Prospectus before the legal proceedings are initiated. Civil liability is only attached to those persons who have tabled the summary including any translation thereof, but only where the summary is misleading, inaccurate or inconsistent, when read together with the other parts of the Prospectus, or where it does not provide, when read together with the other parts of the Prospectus, key information in order to help investors when considering whether to invest in such securities.

The Bank declares that the Prospectus, of which this summary is a part, was compiled in connection with the admission of shares in the Bank to trading on the regulated market of Nasdaq Iceland hf. The use of the description is not permitted for any other purpose.

Issuer	Íslandsbanki hf., ID No. 491008-0160
Issuer's address	Hagasmári 3, 201 Kópavogur, Iceland
ISIN	IS0000028538
Issuer's legal entity identifier (LEI)..........................	549300PZMFIQR79Q0T97
Issuer's website	www.islandsbanki.is
Issuer's phone number	+354 440 4000
Selling shareholder	Icelandic State Financial Investments
Selling shareholder's legal entity identifier (LEI)......	6488047M1L91ULCEC736
The competent authority approving the Prospectus ..	Fjármálaeftirlit Seðlabanka Íslands kt. 560269-4129 Kalkofnsvegur 1, 101 Reykjavík, Iceland email: lysingar@sedlabanki.is
Date of approval of this Prospectus..........................	7 June 2021

B. Key information about the Bank

Who is the issuer of the securities?

The Bank is a public limited company established for an indefinite period on 9 October 2008 under the Public Limited Companies Act with ID number 491008-0160 in the Register of Enterprises of Iceland. The Bank is domiciled in Iceland, and its registered address is located at Hagasmári 3, 201 Kópavogur, Iceland. The Bank's telephone number is +354 440 4000. The Bank's legal entity identifier (LEI) is 549300PZMFIQR79Q0T97.

The Bank is licensed as a commercial bank in Iceland in accordance with item 1 of Article 4(1) of the Financial Undertakings Act and offers comprehensive services to the retail and corporate sectors. The Bank is one of Iceland's three main banks and maintains a strong market share across the spectrum of banking services in the country. According to surveys by Gallup in Iceland in December 2020, the Bank had approximately 31% of the market share in Personal Banking, 35% of the market share in Business Banking and 35% of the market share of Corporate & Investment Banking. The Bank seeks to move Iceland forward by empowering its customers to succeed and prioritise sustainability as an integral driver of strategy and value creation.

As at the date of this Prospectus, the Icelandic state, through Icelandic State Financial Investments on behalf of the Treasury of Iceland (the "**Selling Shareholder**") and Eignarhlutir ehf., owns 100 per cent. of the Bank's issued share capital (the "**Shares**"). The Bank is not directly or indirectly owned or controlled by parties other than the Icelandic state, through the Selling Shareholder.

Set forth below are the members of the Bank's Board of Directors, their year of birth, the year of their initial election to the Board of Directors, their position and whether or not they are considered to be independent of the Bank and the Selling Shareholder pursuant to the Corporate Governance Guidelines and the corporate governance statement of the Bank (*stjórnarháttayfirlýsing*), as confirmed by the Bank's Board of Directors on 10 February 2021:

Name	Position	Year of birth	Director since	Independent
Hallgrímur Snorrason	Chairman of the Board of Directors	1947	2016	Yes
Anna Þórðardóttir	Member of the Board of Directors	1960	2016	Yes
Árni Stefánsson	Member of the Board of Directors	1966	2016	Yes
Frosti Ólafsson	Member of the Board of Directors	1982	2020	Yes
Guðrún Þorgeirsdóttir	Member of the Board of Directors	1979	2020	Yes
Heiðrún Jónsdóttir	Member of the Board of Directors	1969	2016	Yes
Jökull H. Úlfsson	Member of the Board of Directors	1963	2021	Yes

Set forth below are the members of the Bank's Executive Committee, their year of birth and the year in which they were appointed to their current positions on the Executive Committee.

Name	Position	Year of birth	Appointed
Birna Einarsdóttir	Chief Executive Officer	1961	2008
Jón Guðni Ómarsson	Chief Financial Officer	1976	2011
Guðmundur Kristinn Birgisson	Chief Risk Officer	1967	2018
Riaan Dreyer	Managing Director, Information Technology	1975	2019
Sigríður Hrefna Hrafnkelsdóttir	Managing Director Personal Banking	1977	2017
Una Steinsdóttir	Managing Director Business Banking	1966	2008
Ásmundur Tryggvason	Managing Director Corporate and Investment Banking	1975	2019

In accordance with Article 4 of Act No. 46/2016 on the Auditor General and auditing of central government accounts, external auditing of public limited companies in which the Icelandic state is the majority owner is the responsibility of the Auditor General. Furthermore, the provisions of the Act allow the Auditor General to contract external auditors, audit firms and other specialists to work on his/her behalf on individual tasks that the Icelandic National Audit Office ("**INAO**") is responsible for.

Under its previous ownership, the Bank selected Ernst & Young ehf. as its external auditors based on a selection process run by the Audit Committee. Following the Icelandic state's acquiring of all shares in the Bank, Ernst & Young ehf. has carried on their duties as external auditors based on arrangements with INAO. Upon expiry, the agreement was extended for an additional two years, the current fiscal year being the latter of the two years.

Key financial information regarding the Bank

Consolidated Income Statement Data*

	Three months ended 31 March		Year ended 31 December		
	2021	**2020**	**2020**	**2019**	**2018**
			(ISK in millions)		
Net interest income	8,190	8,580	33,371	32,822	31,937
Net fee and commission income	2,862	2,491	10,525	10,899	12,227
Other net operating income	546	(1,664)	(743)	1,444	823
Total operating income	**11,598**	**9,407**	**43,153**	**45,165**	**44,987**
Total operating expenses	(6,445)	(6,279)	(25,013)	(28,952)	(32,104)
Profit before net impairment on financial assets	**5,153**	**3,128**	**18,140**	**16,213**	**12,883**
Net impairment on financial assets	(518)	(3,490)	(8,816)	(3,480)	1,584
Profit (loss) before tax	**4,635**	**(362)**	**9,324**	**12,733**	**14,467**
Income tax expense	(1,036)	(769)	(2,472)	(3,909)	(4,734)
Profit (loss) for the period from continuing operations	**3,599**	**(1,131)**	**6,852**	**8,824**	**9,733**
Discontinued operations, net of income tax	16	(245)	(97)	(370)	912
Profit (loss) for the period	**3,615**	**(1,376)**	**6,755**	**8,454**	**10,645**

*For the three months ended 31 March 2020, and the years ended 31 December 2020 and 2019, the subsidiary Borgun hf. ("**Borgun**") was classified as discontinued operations.

Consolidated Statement of Financial Position Data

	As at 31 March	As at 31 December		
	2021	**2020**	**2019**	**2018**
		(ISK in millions)		
Assets				
Cash and balances with Central Bank	88,748	78,948	146,638	135,056
Loans to credit institutions	103,333	89,920	54,376	41,577
Bonds and debt instruments	103,627	128,216	52,870	69,415
Derivatives	2,536	6,647	5,621	4,550
Loans to customers	1,029,415	1,006,717	899,632	846,599
Shares and equity instruments	25,763	14,851	18,426	13,074
Investments in associates	841	775	746	682
Property and equipment	7,191	7,341	9,168	5,271
Intangible assets	3,357	3,478	4,330	5,002
Other assets	17,566	4,125	6,608	7,947
Non-current assets and disposal groups held for sale	2,858	3,173	1,075	1,230
Total assets	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**
Liabilities				
Deposits from Central Bank and credit institutions	31,565	39,758	30,925	15,619
Deposits from customers	698,575	679,455	618,313	578,959
Derivative instruments and short positions	9,533	6,936	6,219	5,521
Debt issued and other borrowed funds	398,225	387,274	306,381	300,976
Subordinated loans	25,259	27,194	22,674	16,216
Tax liabilities	5,947	5,450	7,853	7,150
Other liabilities	30,660	11,920	27,063	29,649
Total liabilities	**1,199,764**	**1,157,987**	**1,019,428**	**954,090**
Equity				
Share capital	10,000	10,000	10,000	10,000
Share premium	55,000	55,000	55,000	55,000
Reserves	6,353	6,181	7,065	6,499
Retained earnings	113,335	113,529	105,569	102,496
Total shareholders' equity	**184,688**	**184,710**	**177,634**	**173,995**
Non-controlling interests	783	1,494	2,428	2,318
Total equity	**185,471**	**186,204**	**180,062**	**176,313**
Total liabilities and equity	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**

Consolidated Statement of Cash Flows Data

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
			(ISK in millions)		
Net cash (used in) provided by operating activities	269	3,599	(80,724)	18,333	(101,519)
Net cash (used in) provided by investing activities	(34)	(371)	(2,964)	(552)	3,291
Net cash (used in) provided by financing activities	14,385	2,136	46,715	(8,281)	54,186
Net increase (decrease) in cash and cash equivalents	14,620	5,364	(36,973)	9,500	(44,042)
Effects of foreign exchange rate changes	(54)	177	160	(222)	(193)
Cash and cash equivalents at the beginning of the period	115,668	152,481	152,481	143,203	187,438
Cash and cash equivalents at the end of the period	**130,234**	**158,022**	**115,668**	**152,481**	**143,203**

Key risks that are specific to the Bank

- The Bank is exposed to credit risk and may be unable to sufficiently assess credit risk of potential borrowers and may provide advances to customers that increase the Bank's credit risk exposure, and its customer loan portfolio also contains certain problem and impaired loans.
- Increases in the Bank's loan losses or allowances for loan losses may have an adverse effect on its results.
- The Bank is exposed to increasing competition and expects competition will increase.
- The Bank is exposed to Iceland's key industry sectors, particularly seafood, real estate, and tourism.
- The asset management operations of the Bank may fail to sustain or increase their level of assets under management and is subject to pressure on fee margins.
- The Bank relies on key members of management.
- The strength of the Icelandic economy remains vulnerable to a range of domestic and international economic and political factors.
- COVID-19 may have an adverse impact on the Bank.
- The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages.
- Regulatory changes or enforcement initiatives could adversely affect the Bank's business.
- The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities.

C. Key information on the securities

What are the main features of the securities?

The securities' type, class and ISIN	The securities that are to be admitted to trading are shares in the Bank. The Bank's shares are all in one class and equal in all respects according to the Bank's Articles of Association. The shares in the Bank are issued in accordance with Act No. 2/1995 on public limited companies. The shares are electronically registered at the Nasdaq CSD Iceland in accordance with Act No. 7/2020 on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments and any subsequent rules based thereon. The shares will be registered under the ticker symbol "ISB" and ISIN IS0000028538.
Currency of the securities issued	Icelandic króna (ISK).
The par value per share	The share capital of the Company amounts to ISK 10,000,000,000. The share capital is divided into 2,000,000,000 shares of ISK five (5) in nominal value, or multiples thereof.
The rights attached to the securities	All shares have equal rights and no special rights are attached to any of the shares. One vote is attached to each Icelandic Króna of share capital in the Bank at shareholders' meetings. Shareholders' rights at any given time are subject to the Bank's Articles of Association and applicable legislation.
Relative seniority of the securities in the Company's capital structure in the event of insolvency	Upon liquidation or bankruptcy of a public limited company, shareholders are paid in proportion to their share capital holdings using the remainder of the public limited company's assets after all other creditors have had their valid claims paid.
Restrictions on the free transferability of the securities	The shares are freely transferrable unless otherwise stipulated by law, including Act No. 7/2020 on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments and any subsequent rules based thereon.
Dividend policy	Based on the then-applicable regulatory requirements, the Bank is targeting to pay out approximately 50% of earnings as a base dividend. The Bank will focus on excess capital to support further dividend payments, buybacks and/or ROE enhancing growth. ***Special distributions and dividend capacity*** The Bank anticipates additional capital return to approach capital targets over the medium term. However, the speed and quantum of such special distributions, for example, in the form of a share buyback or extraordinary dividend, would depend on a number of factors, including (but not limited to) management of foreign exchange imbalances, the Bank's liquidity position, access to capital markets, the capital requirements set by the FSA, recommendations from the European Banking Authority ("**EBA**") and more. Such returns would likely take place over a number of years. The Bank is currently subject to restrictions in distributing dividends and repurchasing shares due to the COVID-19 pandemic. Such distribution may not exceed 25% of accumulated profit in 2019 and 2020 or 0.4% decrease in Tier 1 capital, whichever is lower. This restriction applies until 30 September 2021 and is based on recommendations from EBA. It is uncertain whether and how any such restrictions will be extended.

In its opinion, the Board of Directors indicated that it would be reasonable to postpone all additional equity distribution until the uncertainty resulting from the COVID-19 pandemic has been reduced.

The Board of Directors formulated the dividend policy as outlined above in connection with the Offering and in order to promote the success of the Offering, and accordingly considered that adopting the dividend policy was in the best interests of the Bank.

Where will the securities be traded?

Following the approval of the Prospectus by the Financial Supervisory Authority of the Central Bank of Iceland and the completion of the Offering, the Board of Directors of the Bank will request that the shares in the Company be admitted to trading on the regulated market of Nasdaq Iceland hf., which is a regulated securities market.

Is there a guarantee attached to the securities?

Not applicable. The securities are not subject to guarantee.

What are the key risks that are specific to the securities?

- The market price of the Offer Shares may fluctuate and could fall below the Offer Price.
- Substantial future sales of Shares could adversely affect the market price of the Shares.
- The Bank's ability to declare a dividend in the future is subject to a variety of factors, and the Bank cannot guarantee that dividends will be payable or paid in the future, or that, if they are paid, that they will increase over time.
- Exchange rate fluctuations could have an adverse impact on the value of a non-Icelandic holder's Offer Shares and dividends.

D. Key information about the offering and admission to trading on a regulated market

Under which conditions and timetable can I invest in this security?

The Offering applies to already issued shares in the Bank held by the Selling Shareholder, to be offered in the form of Existing Offer Shares. The Selling Shareholder will closely consult with the Joint Global Coordinators and agree on the final number of the Offer Shares sold in the Offering. The price at which the Offer Shares will be sold (the "**Offer Price**") is expected to be between ISK 71 and ISK 79 per Offer Share and will be determined through a book-building process. The Offer Price will be set in ISK.

Subject to any acceleration, extension or postponement of the timetable for the Offering, the offer period in respect of the public offerings in Iceland begins on 7 June 2021 at 09:00 GMT and ends on 15 June 2021 at 12:00 GMT (the "**Offer Period**"). No orders will be accepted after the Offer Period has ended (unless the Selling Shareholder specifically decides to postpone the Offering or to extend it and in such cases a supplement to this Prospectus will be published, as applicable).

It is expected that the result of the Offering will be published on 15 June 2021 and posted on the Bank's website. It is furthermore expected that Nasdaq Iceland will subsequently respond to the Bank's applications to admit the Shares to trading on the regulated market of Nasdaq Iceland. Subsequently, information on the allocation of the Offer Shares to investors in the Offering (i.e. confirmation or reduction of subscriptions) will be sent to investors, expected on 16 June 2021 if Nasdaq Iceland have responded positively. The final due date for payment of the allocated shares is then set for 21 June 2021 and paid Offer Shares are expected to be delivered to the investors within two business days after payment is received.

The Selling Shareholder will cancel the Offering if Nasdaq Iceland rejects the Bank's application to have all Shares in the Bank admitted to trading on the regulated market of Nasdaq Iceland. The Selling Shareholder reserves the right to cancel the Offering if orders are not received for at least the minimum number of the Offer

Shares in the Offering, if it is not able to obtain a satisfactory Offer Price within the Offer Price Range, or for any other reason in its sole discretion. If the Offering is cancelled pursuant to the above, all orders for Offer Shares in the Offering and allocations made on the basis thereof will be invalidated as a result. It will be publicly announced if the Offering is cancelled or if the Offer Period is accelerated, extended or postponed, following which (other than in the case of cancellation of the Offering) a supplement to this Prospectus will be prepared, approved and published in accordance with Article 23 of the Prospectus Regulation and Article 5 of the Prospectus Act, as applicable. In such case (other than in the case of cancellation of the Offering), investors may be able to withdraw their orders.

Investors in the public offering in Iceland can obtain information on the Offering and the order website from the Bank at www.islandsbanki.is/utbod. Further information on the Offering for investors participating in Tranche A is available from the Bank at tel. +354 440 4000 or via email verdbref@islandsbanki.is, and for those investors participating in Tranche B via tel. +354 440 4000 or via email ipo@islandsbanki.is. Investors can obtain this information by phone or e-mail between 09:00 and 16:00 GMT during the Offer Period.

Why is the prospectus being produced?

This Prospectus is produced in connection with the offering and admission to trading of shares in the Bank. The Bank bears all cost associated with the admittance of the Offer Shares to trading. The total cost borne by the Bank is estimated to be ISK 750 million and consists of costs associated with the scrutiny and approval of the Prospectus including paid overtime to employees, the Nasdaq Iceland listing fees, fees to its advisors, along with other costs directly associated with the admittance to trading. The Selling Shareholder bears all costs associated with the marketing and selling of the Offer Shares.

The Bank will not receive any proceeds from any sale of the Offer Shares by the Selling Shareholder, all of which will be paid to the Selling Shareholder. The gross proceeds from the Offering to be received by the Selling Shareholder will be approximately ISK 42,614 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised).

The aggregate underwriting commissions, other fees and expenses to be paid by the Selling Shareholder in connection with the Offering are expected to be up to approximately ISK 1,378 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range and the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised). The net proceeds to be received by the Selling Shareholder will be approximately ISK 41,236 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised).

The Bank, the Selling Shareholder and the Managers entered into an underwriting agreement (the "**Underwriting Agreement**") with respect to the Offer Shares to be sold by the Selling Shareholder in the Offering. Subject to certain conditions set forth in the Underwriting Agreement, the Selling Shareholder has agreed to sell to the purchasers procured by the Managers or, failing which, to the Managers, and each of the Managers, severally, has agreed to procure purchasers for, or failing such procurement, each of the Managers has agreed to purchase from the Selling Shareholder, as the case may be, the percentage of the Offer Shares listed opposite such Manager's name below.

Manager	**Percentage Offered in the Offering**
Citigroup Global Markets Europe AG	36.54%
Íslandsbanki hf.(*)	—
J.P. Morgan AG	36.54%
Barclays Bank Ireland PLC	13.28%
HSBC Continental Europe	6.64%
Fossar Markaðir hf. (*)	—
Landsbankinn hf.	3.00%
Arion banki hf.	2.00%
Kvika banki hf.	2.00%
Arctica Finance hf. (*)	—
Íslenskir fjárfestar hf. (*)	—

Manager	Percentage Offered in the Offering
Íslensk verðbréf hf. (*)	—
Total	**100.0%**

(*) Acting as Manager but not underwriting any Offer Shares

The Underwriting Agreement provides that the obligations of the Managers to procure purchasers for, or failing which the obligation of the Managers to purchase, the Offer Shares are subject to certain conditions and may be subject to termination by the Managers under certain customary circumstances. Should the Managers decide to terminate their several commitments, the Offering may be cancelled; if cancelled, no Offer Shares will be delivered. Pursuant to the Underwriting Agreement, the Bank will indemnify the Managers against certain liabilities and related costs or will contribute to payments that the Managers may be required to make as a result of any such liabilities.

There are no material conflicts of interest pertaining to the offering and admission of trading of shares in the Bank.

RISK FACTORS

Any investment in the Offer Shares is subject to a number of risks. Prior to investing in the Offer Shares, prospective investors should carefully consider risk factors associated with any investment in the Offer Shares, the Bank's business and the industry in which it operates together with all other information contained in this Prospectus, including, in particular, the risk factors described below.

Prospective investors should note that the risks relating to the Bank, its industry and the Offer Shares summarised in "Summary" are the risks that the Bank believes to be the most relevant to an assessment by a prospective investor of whether to consider an investment in the Offer Shares. However, as the risks which the Bank faces relate to events and depend on circumstances that may or may not occur in the future, prospective investors should consider not only the information on the key risks summarised in "Summary" but also, among other things, the risks and uncertainties described below.

The following list of material risk factors is not an exhaustive list or explanation of all risks which investors may face when making an investment in the Offer Shares and should be used as guidance only. Additional risks and uncertainties relating to the Bank that are not currently known to it, or that the Bank currently deems not to be risks, may individually or cumulatively also have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations and, if any such risk should occur, the price of the Offer Shares may decline and investors could lose all or part of their investment. Investors should consider carefully whether an investment in the Offer Shares is suitable for them in light of the information in this Prospectus and their personal circumstances.

The Bank has assessed the materiality of the risk factors based on the probability of their occurrence and the expected magnitude of their negative impact and has organised the following risk factors accordingly within each category, beginning with those estimated to be most significant to the Bank. The order in which the categories of risk factors are presented does not necessarily reflect the probability of their occurrence or the magnitude of their potential impact, as the categories of risk factors mentioned herein could materialise individually or cumulatively. Any quantification of the significance of each individual category for the Bank could be misguiding, as other categories of risks factors may materialise to a greater or lesser degree.

Risks Relating to Business and Industry

1. The Bank is exposed to credit risk and may be unable to sufficiently assess credit risk of potential borrowers and may provide advances to customers that increase the Bank's credit risk exposure, and its customer loan portfolio also contains certain problem and impaired loans

Credit risk is defined as the 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. The Bank is exposed to credit risk by offering credit products such as loans and guarantees. As at 31 March 2021, the Bank's maximum exposure to credit risk amounted to ISK 1,518,929 million (ISK 1,469,794 million as at 31 December 2020). The two main risks relate to the borrower's ability and willingness to pay and in the event of default, the value and enforceability of any collateral if secured against the loan. The Bank's credit risk governance framework is intended to manage the Bank's credit risk exposure within the appetite approved by the Board. However, the risk remains that the Bank could become exposed to more credit risk than what it defines as acceptable. The Bank could, for example, miscalculate the risk attached to a particular loan application or the overall long-term financial viability of borrowers. There is a risk that the Bank could take on too much credit risk if there is a dip in the Icelandic or global economy. In addition, the Bank's employees could fail to comply with the Bank's risk management policies and therefore sign the Bank up to riskier loans than would be permitted under the policies.

The Bank faces a concentration of loans and deposits in the geographic segment in which it operates. Geographically, the Bank's loans are largely concentrated in Iceland (97% of the Bank's loan portfolio as at 31 December 2020). With respect to liabilities, 97% of its deposits were from Icelandic depositors at 31 March 2021 (unchanged from 31 December 2020).

The Bank's portfolio of bonds and debt instruments, including the Bank's liquidity portfolio, also has a concentration of Icelandic credit risk, with 74%, 66%, 41% and 40% of the portfolio representing Icelandic government and private sector bonds held by the Bank at 31 March 2021, 31 December 2020, 31 December 2019 and 31 December 2018. Accordingly, the Bank is particularly exposed to any future downturn in the economy of Iceland.

Customers may experience difficulties in meeting their debt obligations should the economic conditions in Iceland become unfavourable, or if issues arise in relation to a particular customer, group of customers or industry. Furthermore, if the Bank decides to enforce collateral or instigate bankruptcy proceedings against a customer who has failed to meet their obligations, this could negatively impact on other customers of the Bank. For example, the Bank could have some customers who have equity in entities which fail to meet their repayment obligations, who will therefore be at risk of financial loss if the Bank takes enforcement action against the borrower.

In particular:

- as at 31 March 2021, 2.4% of the Bank's customer loan portfolio was classified as non-performing based on the gross carrying amount (2.9% as at 31 December 2020, 3.0% as at 31 December 2019 and 2.0% as at 31 December 2018), and the Group's impairment allowance on its customer loan portfolio amounted to 1.7% (1.7% as at 31 December 2020, 1.1% as at 31 December 2019 and 0.9% as at 31 December 2018) of the total gross amount of the portfolio. As at 31 March 2021, the value of collateral that the Group held relating to credit-impaired loans amounted to ISK 15,949 million, or 65%, of the aggregate carrying amount of the non-performing loans (ISK 20,546 million as at 31 December 2020 (70%), ISK 20,590 million as at 31 December 2019 (75%) and ISK 12,206 million as at 31 December 2018 (71%)). The percentage of loans to individuals (mostly mortgage loans) that are classified as non-performing has increased from 2% as at 31 December 2018 to 3.0% as at 31 December 2019, 2.9% as at 31 December 2020 and 2.4% as at 31 March 2021. The average LTV for mortgages was 65%, compared to 64% as at 31 December 2020, 62% as at 31 December 2019 and 61% as at 31 December 2018. The increase is due to new lending;

- the Bank has significant lending exposure to the real estate, commerce and services and seafood industry sectors, with exposure amounting to 15.3%, 11.6% and 12.0%, respectively, of the total net carrying value of the Bank's customer loan portfolio as at 31 March 2021 (15.6%, 12.3% and 12.1%, respectively, as at 31 December 2020; and

- as at 31 March 2021, the Bank had one large exposure that, after eligible credit risk mitigating effects, amounted to 10% of capital base (unchanged from 31 December 2020). This is an increase from 31 December 2019, when the Bank had no large exposure. A large exposure is defined as an exposure to a group of connected clients that is 10% or more of the Bank's total capital base. The exposure is evaluated both before and after the application of eligible credit risk mitigating effects according to relevant rules. When assessing the exposure, both on-balance sheet items and off-balance sheet items from all types of financial instruments are included. The Bank has internal criteria that define connections between clients in line with Icelandic law and EBA guidelines, where groups of connected clients are defined.

Exposure to borrowers in countries other than Iceland amounted to ISK 136 billion as at 31 December 2020. This exposure relates mainly to the management of the Bank's foreign liquidity reserves. The Bank has no retail lending activities outside of Iceland but maintains a modestly sized portfolio of lending to companies in the United States, Canada and Norway within its North Atlantic strategy. The overseas strategy is built on a heritage of servicing the core industries in Iceland, primarily focusing on the seafood industry. As at 31 December 2020, the Bank's exposure to companies within this portfolio was ISK 28 billion as at 31 December 2020. The Bank's portfolio of loans to borrowers in the seafood industry are dependent on both political and climate considerations, as political decisions on fishing quotas and the impact of climate change can have a significant adverse effect on the value of the collateral the Bank holds in respect of these loans.

As at 31 December 2020, credit risk and credit concentration risk accounted for 85% of the total of SREP capital requirements. As at 31 December 2020, the Bank's maximum credit exposure to central governments was ISK 187,260 million.

To the extent that any of the instruments and strategies the Bank uses to hedge or otherwise manage its exposure credit risk are not effective, it may not be able to effectively mitigate its risk exposures in particular market environments or against particular types of risk. The Bank's earnings will depend upon how its critical accounting estimates prove accurate and upon how effectively it determines and assesses the cost of credit and manages its risk concentrations.

2. Increases in the Bank's loan losses or allowances for loan losses may have an adverse effect on its results

The Bank's banking businesses establish provisions for loan losses, which are reflected in the provision for credit losses on its income statement, in order to maintain its allowance for loan losses at a level which is deemed to be appropriate by management based upon an assessment of prior loss experience, the volume and type of lending being conducted by each entity, industry standards, past due loans, economic conditions and other factors related to the collectability of the loan portfolio. Although the Bank's management uses its best efforts to establish the provision for loan losses, that determination is subject to significant judgement, and the Bank's banking businesses may have to increase or decrease their provisions for loan losses in the future as a result of increases or decreases in non-performing assets or for other reasons, such as an inability to enforce contractual provisions, whether as a result of retroactive legislation, court rulings or otherwise. To the extent its assumptions or estimates used in establishing its valuation models for the fair value of its assets and liabilities or for its loan loss reserves prove inaccurate or not predictive of actual results, it could suffer higher than anticipated losses. Any increase in the provision for loan losses, any loan losses in excess of the previously determined provisions with respect thereto or changes in the estimate of the risk of loss inherent in the portfolio of non-impaired loans could have a material effect on the Bank's results of operations and financial condition.

The Bank's loan portfolio grew by 11.9% in 2020 after a 6.3% increase in 2019. The Bank's risk exposure amount increased by ISK 48 billion (approximately 5%) during 2020. The largest increase was due to growth in the mortgage loan portfolio (ISK 42 billion), exposures to financial institutions (ISK 7 billion) stemming from the foreign exchange liquidity portfolio and an increase in market risk exposure (ISK 9 billion), mainly due to a shift in the liquidity portfolio to bonds and debt instruments when the Central Bank of Iceland halted one-month term deposits. While the Bank's business divisions monitor their loan portfolios and periodically re-assess customer performance, there is nonetheless an increased exposure to risk related to the increase in the loan portfolio.

As a result of IFRS 9, the Bank must recognise credit losses on loans and other financial instruments based on expected losses in addition to incurred losses. Increased volatility in the Bank's income statement and to its regulatory capital ratios is expected to arise from the incurred credit loss impairment process because changes in counterparty credit quality could generate changes to expected loss levels on a more frequent basis. In addition, pursuant to IFRS 9, certain financial instruments may be classified at fair value, further increasing volatility in the Bank's consolidated income statement. An increase in credit loss provisions could have impact on the Bank's lending activities and the potential for greater pro-cyclicality on lending and provisioning exists due to IFRS 9.

3. The Bank could experience credit rating downgrades

The Bank has been rated BBB/A-2 by S&P Global Ratings. S&P Global Ratings rate the Bank by assessing its creditworthiness. The Bank's rating is and will continue in part to be based on some factors which are outside of the Bank's control, such as the economic conditions affecting Iceland. The credit ratings are revised and updated periodically and there are no guarantees that the Bank will be able to maintain its current rating. There is a risk that the rating agency could reduce the Bank's credit rating or could change the way they calculate the credit rating. The credit rating should not prevent investors from performing their own analysis of the Bank.

If the Bank's credit rating or the rating of its financial instruments is downgraded, this could have an effect on the Bank's access to capital markets and particular financial instruments. The Bank's ability to retain clients could reduce, the Bank's funding costs could increase and there could be a negative impact on sales and marketing of products as a result of a downgrade. A downgrade in credit rating could require the Bank to provide more collateral in derivatives contracts and secured funding arrangements.

4. The Bank is exposed to increasing competition and expects competition will increase

The banking sector in Iceland is largely dominated by the Bank, Arion Bank and Landsbankinn (the latter being wholly owned by the Icelandic state, and each of which is classified as a systemically important financial institution). In addition, with the merger of Kvika Bank hf., an investment bank, TM hf., one of the largest insurance companies in Iceland, and Lykill fjármögnun hf., an asset leasing entity, the merged company provides these three large Icelandic banks with increased competition. Moreover, there are other players in the industry, such as pensions funds, commercial banks, savings banks and the Housing and Construction Authority (formerly the Housing Financing Fund), whose role in the market as a lender has been reduced and is now responsible for implementation of government housing policies and acting as an intermediary for social housing funding, all of which the Bank competes with and which can impose a degree of pressure on the Bank's net interest margin. Moreover, as additional channels arise for new lending and other banking products, particularly in the online space, the Bank faces increasing competition from these market participants.

Pension funds offer mortgage lending to individuals at competitive interest rates, which is in part due to the fact that they are not subject to the Bank Levy. Icelandic pension funds also compete for the Bank's deposits, as a vast proportion of the population of Iceland's savings are held in pension funds rather than as bank deposits. As required by law, a significant portion of salaries, as well as a contribution by employers, goes into pension funds. Pension funds are purchasers of the Bank's covered bonds and therefore represent a significant source of the Bank's funding in Icelandic Króna. In addition, the Icelandic government introduced legislation in 2013 to promote competition between banks by making it easier for customers to move between banks. For example, the legislation removed stamp fees on collateral and limited prepayment fees on consumer loans, which has increased the rate of refinancing. There is no certainty that the Bank will be able to obtain funding at similarly low interest rates in order to maintain net interest margin.

The Bank is under considerable regulatory scrutiny, which limits how competitive it can be, particularly as fintech companies and initiatives, innovative payment services providers and companies using blockchain and distributed ledger technologies may compete with the Bank because they are not subject to the same scrutiny from regulators. The pending implementation of Payment Services Directive 2 in Iceland has increased the regulatory burden for the Bank, as well as competitive pressure. There is also a higher level of regulatory scrutiny for the Bank because it is a systemically important financial institution in Iceland. For example, the Icelandic Competition Authority (*Samkeppniseftirlitið*) (the "**ICA**") carried out an investigation into the Bank, Arion Bank and Landsbankinn in relation to the alleged abuse of their dominant position in the market in relation to their mortgage loan arrangements. That investigation was concluded with a settlement with the ICA in which the Bank agreed to take certain measures, which have the objective of stimulating competition in banking services for individuals and small businesses. The measures also aim to reduce circumstances that could lead to tacit coordination in the market for retail banking services in Iceland to reduce the costs for customers in switching financial services providers. Under the Competition Act, a failure to implement or comply with measures agreed to in a settlement can lead to an investigation lead by the ICA and could ultimately result in administrative fines being imposed.

The Bank could face increased competition from foreign banks and foreign financial, banking and payment services providers (including fintech companies and related initiatives) who wish to establish operations in Iceland, in particular with respect to the customers of the Corporate & Investment Banking division. Foreign banks and companies could have a competitive advantage in the market because they may not be subject to the stringent regulatory requirements which the Bank is subject to as a systemically important financial institution in Iceland and could have lower funding costs. Additionally, foreign banks and companies may have more resources available to them to provide wider-ranging services and at higher efficiency given the relatively small size of the Bank. Foreign banks and companies may be able to focus more time and resources on business development and expanding their customer base and may be able to lend greater amounts to customers or absorb a larger reduction in margins. Externally, the Bank estimates that foreign banks, companies and lending institutions hold approximately 30% of the market share in loans to large companies. While these external foreign banks and companies have not acted aggressively in the Icelandic market in recent years, they still offer competitive margins on senior secured loans to the largest seafood companies.

Equally, the investment banking and wealth and asset management markets are highly competitive with many active market participants. Alongside mergers in this regard and the further introduction of fintechs and innovative initiatives challenging existing business models and technologies, this presents risk of exposure to the Bank in the form of increased competition.

The Bank expects to be able to continue to compete in the banking sector on the basis of its reputation, products and services on offer, local knowledge of the sector, ability to execute transactions and focus on innovation. If the Bank becomes unable to compete effectively in a market in which it has a significant presence, this could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

5. The Bank is exposed to Iceland's key industry sectors, particularly seafood, real estate, and tourism

Iceland's economy is largely made up of select number of industries. Exports accounted for 34% of Iceland's gross domestic product ("**GDP**") in 2020. Iceland's largest exports are seafood, aluminium, tourism, and other industrial goods, which accounted for 26.9%, 20.8%, 11.7% and 9.1%, respectively, of total exports in 2020. (*source: IMF, Statistics Iceland*).

Key risks in these industry sectors include:

- *Seafood:* Iceland's seafood industry sector is focused on fishing, farming and processing seafood. The seafood industry is reliant on there being large sources of seafood species and international demand. If either decrease, or if there is a significant appreciation of Icelandic Króna, this could have a material adverse effect on Iceland's seafood industry sector. The seafood industry sector is also subject to political risks, such as decisions on fishing quotas, and climate change, both of which can have a material adverse effect on the sector.

- *Real Estate:* Increased real estate development follows an increase in the population of Iceland, which is also driven by net immigration. However, if there is a decline in the economy of Iceland or the demand for real estate decreases for another reason, this could have a material adverse effect on the real estate industry sector in Iceland. The real estate market has not been as heavily affected by the COVID-19 pandemic partially due to the excess demand of real estate and the reduction in the Central Bank of Iceland's key interest rate from 3.0% to 0.75%, which was most recently increased in May 2021 to 1.0%. This reduction has resulted in decreased debt burdens and easier access to mortgages. In fact, housing prices have been on the rise over the past year, and currently the market is demand-driven as supply is lacking.

- *Commerce and services:* The sector covers a wide range of companies, including hotels, car rentals, car dealerships, retail stores and other service companies. A large part of the sector falls also under the scope of the tourism industry. Therefore, the sector is heavily dependent on the number of tourists that visit Iceland. The tourism industry is an important economic sector in Iceland, but due to the nature of tourism, its effects are not limited to hotels, car rentals and tour guides. The Bank therefore monitors the tourism industry internally as a quasi-sector instead of a separate sector. Additionally, the Bank's direct exposure to companies operating in the tourism industry sector is 9%, with the industry significantly affected by COVID-19. In Iceland, tourism has been the sector hardest hit by COVID-19, and its development and recovery following COVID-19 remain uncertain. The substantial majority of the portfolio of loans to companies in this sector was moved to Stage 2 under IFRS 9. This led to a rise in the proportion of loans for which there has been a significant increase in credit risk from origination (stage 2), to 15.6% as at 31 December 2020 compared to 2.6% as at 31 December 2019. This proportion decreased to 14.7% as at 31 March 2021. The worsening economic outlook also impacted loan impairments, as the forward-looking impairment method under IFRS 9 ensures that reserves are put aside for expected losses although actual losses have not been incurred. Defaults have not yet followed and in fact, the non-performing loan ("**NPL**") ratio has decreased since 31 December 2019 and to 2.9% as at 31 December 2020 and 2.4% as at 31 March 2021.

Should the Bank experience a decline in any of these industry sectors for any reason, including natural disasters or other events outside the Bank's control, this could result in more non-performing loans (particularly in the Corporate & Investment Banking division), a reduced demand for mortgage loans (in the Personal Banking and Business Banking division) and also wider problems for the Icelandic economy.

6. The Bank is exposed to a range of other typical financial institution market risks, including interest risk and equity price risks as well as inflation risk

The Bank is exposed to various market risks and may be impacted by events that affect the equity market in general. Market risk is defined 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, inflation, equity prices and foreign exchange rates. Market risk is a key risk to the Bank's operations. The Bank's market risk strategy aims at maintaining a modest market risk profile.

Market risk

Market risk at the Bank is split into two categories: risk in the trading book and risk in the banking book. Market risk due to mismatches in assets and liabilities with respect to currencies, interest reset dates and the Consumer Price Index ("**CPI**")-indexation falls in the banking book. Market risk in the banking book also includes exposures held for long-term investment purposes, in unlisted securities and holdings in subsidiaries or affiliates. Market risk exposures in the trading book arise in relation to short-term and medium-term trading in securities (mainly equities and government bonds, as well as from bond holdings in the Bank's liquidity portfolio), currencies and other capital market instruments. The positions are undertaken mainly as a part of the Bank's flow trading, through the Bank's liquidity portfolio and as hedges against customers' derivatives contracts. The Bank is also exposed to currency risk in the trading book. The Bank has controls in place to limit its trading book exposure; however, these controls may not be effective in all circumstances, and the Bank could experience material losses in its trading book. The Bank could also experience significant variations in its consolidated income statement and statement of financial position in the Annual Financial Statements due to movements in the market value of marked-to-market securities, for example, where the Bank has obtained derivative contracts which are marked to market in order to hedge certain assets and liabilities, while the value of the underlying assets and liabilities might be valued at amortised cost. The Group's asset management operations, within the Bank's Corporate & Investment Banking division and in the Bank's subsidiary Iceland Funds, are also subject to market risk as there could be fluctuations in the markets in which the asset management operations hold assets.

Interest rate risk

Interest rate risk in the Bank's banking book arises from the Bank's core banking activities, including fixed-rate mortgage loans, covered bond debts and fixed-term deposits. It represents the risk of loss from fluctuations in future cash flows or fair value of financial instruments as market rates change over time, reflecting that the Bank's assets and liabilities are of different maturities and are priced relative to different interest rates. The Bank also faces interest rate risk between its interest-earning assets and interest-bearing liabilities due to different floating rate calculations in different currencies. Interest rates are affected by factors beyond the Bank's control, such as economic conditions in Iceland and elsewhere.

The Bank's interest rate risk is mainly in ISK, both in CPI-linked and non-indexed linked. However, the Bank's interest rate risk is currently different for CPI-linked ISK and non-indexed linked ISK. For non-indexed linked ISK, the Bank is more vulnerable for losses if rates rise. Should interest rates in non-indexed ISK increase, there is a risk that the Bank's interest expense may increase faster than the interest it earns on its loans and other assets increases. For CPI-linked ISK, lower interest rates may cause the Bank's interest income to fall faster than the Bank's interest expense. If interest rates move unfavourably, this could materially adversely affect earnings and cash flow and the value of the Bank's assets and its ability to realise gains or avoid losses from the sale of its assets, which would have an impact on the Bank's net results. The Bank considers interest rate risk to be the most important market risk factor in the banking book and the majority of the Bank's capital requirements due to market risk arise from interest rate risk. Additionally, an increase in interest rate trends could lead to an increase in defaults on loans to customers, and therefore could reduce the demand for loans and the Bank's ability to enter into them.

Refinancing risk

The Bank is also exposed to refinancing and prepayment risk in its mortgage portfolio. Interest rates in Iceland are currently low, which has meant interest-earning assets (such as residential mortgage loans) are generating lower yields upon origination or refinancing and other loans and securities held are also generating lower levels of interest income when compared to historical levels. In addition, the Icelandic government introduced legislation in 2013 to abolish the stamp fee on collateral and has restricted banks on the size of the repayment fees they can charge. It is now easier for the Bank's customers to refinance their debts; therefore, there has been an increase in refinancing as interest rates have decreased. The Bank is exposed to risk of further refinancing and lower interest rates would increase the risk of further refinancing. There can be no certainty that the Bank can obtain funding at similarly low interest rates in order to maintain net interest income.

Inflation risk

The Bank is exposed to inflation risk when there is a disparity between its ISK-denominated assets and liabilities linked to the CPI. This risk arises due to the Bank's involvement in inflation-linked bonds and debt instruments, inflation-linked loans and deposits, and inflation-linked derivatives. As at 31 December 2020, the total amount of the Bank's CPI-linked assets was ISK 272,746 million and the total amount of its CPI-linked liabilities was ISK 246,565 million. In times when there is very low inflation or deflation, CPI-linked assets would generate reduced net interest income, which could have a negative impact on the Bank's net interest margin. CPI-linked assets decrease in value during periods of very low inflation or of deflation. The Bank has adjusted its policy to maintain an inflation imbalance in order to minimise the effect of unanticipated changes in the CPI on the Bank's capital ratios and considers such a position neutral. The Bank aims to maintain a positive inflation imbalance rather than keeping the size of CPI-linked assets and liabilities matched while still allowing the imbalance to vary around the neutral positions. The inflation imbalance in the banking book rose in the first half of 2020 but fell again in the second half of the year, amounting to ISK 21.8 billion at the end of the year compared to ISK 19.6 billion at the end of 2019.

The Bank uses risk management procedures in place to mitigate these risks; however, it cannot be guaranteed that they will be effective in all circumstances. Under certain circumstances, the Bank may be at risk of significant losses, which could impact its prospects and financial position.

7. The asset management operations of the Bank may fail to sustain or increase their level of assets under management and is subject to pressure on fee margins

The Bank earns fixed fees as a percentage of assets under management, as well as variable performance fees dependent on the performance of its funds and the market generally. The Banks operations are therefore influenced by fluctuations in the market value of assets under management and the amounts of assets invested by customers. For the year ended 31 December 2020, the Bank generated ISK 2,382 million, or 5.5% of its operating income, from net fee and commission income of asset management. There is a risk that the Bank could see a decrease in net fee and commission income if there is a decline in the asset management operations of the Bank. Customers can usually withdraw assets (or reduce mandates) from the Bank's management on short notice, and may be included to do so if, for example, a fund or market is underperforming, or they are unhappy with the quality of the Bank's services. In addition, the Bank could lose customers if there is damage to the Bank's reputational or a potential conflict of interest arises. The Bank's previously successful mandates cannot be used to predict future success given changes continually take place in the market, economy, and employees, including key employees, can leave.

In addition, there is a high level of competition in this market which has put pressure on the Bank to reduce its fees, creating pressure on fee margins. The asset management industry has been impacted by the arrival of new competition from fintech companies. This has shaken up the market and put pressure on commissions in various financial services. The Bank will incur cost in responding to these changes in market conditions, and it will be required to employ people with expertise in new areas and look to expand and update its services and products. Whilst the Bank already manages a broad range of asset classes for retail and institutional investors, corporations and high net worth individuals, asset classes can fluctuate in popularity over time. There is a risk that a competitor of the Bank could develop new asset classes and categories of funds which the Bank is not about to offer, which may have higher margins than those offered by the Bank, potentially resulting in losses for the Bank.

Regulators were granted more extensive powers under MiFIR and MiFID 2 and they can impose higher fines on banks if there is an infringement of their requirements. MiFIR and MiFID 2 significantly extended the obligations that were in place under the previous regulations. It is important that the Bank keeps its activities under review and, where necessary, adjusts the manner in which it operates. The Bank also has to provide more information to customers about the costs and charges associated with their investment services. The Bank therefore faces significantly higher compliance costs and is subject to increasingly complex requirements.

8. Price fluctuations of financial investments in the Bank's portfolio could materially affect the Bank's results of operations and financial condition

The Bank has an investment portfolio that includes mainly debt securities. If the price of these securities declines, this could reduce the value of the Bank's securities portfolio. These securities are measured at fair value at the end of each financial period. Declines in the market value of the portfolio could accordingly materially affect the Bank's profitability, even if those declines have not been realised through the sale of the relevant securities. Price fluctuations could also materially affect the Bank's regulatory capital and the capital ratios that the Bank is required to maintain under applicable law.

The Bank is also subject to the equity risk in its trading portfolios and in its banking book. The Bank's equity risk arises from flow trading, market making, shares acquired through restructuring of companies, and strategic investments. Equity exposure in the trading book decreased in 2020 with an average position of ISK 1.3 billion compared to ISK 1.7 billion in 2019. The maximum equity exposure in the trading book was ISK 2.3 billion in

2020 compared to ISK 3.0 billion in 2019. Equity exposure in the banking book, including fair value shares and shares held for sale, also declined from ISK 8.7 billion at the end of 2019 to ISK 5.8 billion at the end of 2020.

9. The Bank is exposed to liquidity risk

Banks are exposed to liquidity risk, meaning uncertainty in the ability of the Bank in adverse economic conditions to access the funding needed to cover the Bank's obligations to its customers as they become due and to meet the maturity of the Bank's liabilities. This includes the risk of unanticipated increases in the cost of funding, the risk of not being able to structure maturity dates of liabilities, being unable to satisfy payment obligations and the risk of unexpected demand for customer loans. The Bank's liquidity risk policy assumes that the Bank always strives to exceed regulatory liquidity ratio limits. The Bank's main source in generating funding is from deposits from customers, which amounted to ISK 679,455 million as at 31 December 2020. Key measures for the assessment of liquidity risk are the LCR and NSFR. As at 31 December 2020, the Bank's LCR was 196% and the NSFR was 123%.

The Bank's funding model is built on few key principles designed to limit refinancing and liquidity risks and to optimise the funding costs and use of proceeds. The Bank has sought to diversify its funding profile and funding mix by issuing senior unsecured and Tier 2 bond issuances in various currencies and covered bonds in the domestic capital markets and diversifying its investor base. The Bank will continue its efforts to diversify its funding if its deposit base declines or fails to grow relative to any increases in its assets. There is an inherent limit to the scope for growth in deposits in light of Iceland's comparatively small economy and the competition for funding with other banks and with pension funds. See "*Industry Overview—The Banking Sector—Corporate & Investment Banking*". The Bank maintained a strong liquidity position throughout 2020, with the year-end balance of deposits rising by approximately ISK 70 billion from 2019 to 2020 and all regulatory and internal metrics above limits. This change was driven by an increase in retail deposits (ISK 53 billion), deposits from large corporations and public sector entities (ISK 7 billion) and in deposits from pension funds, domestic financial institutions, and foreign financial institutions (ISK 10 billion). This meant that the rise in deposits matched that of loans, therefore the loan-to-deposit ratio for households and non-financial corporations did not change significantly between 2019 and 2020. Furthermore, the ability of the Bank to access both domestic and international capital markets will depend on market and economic conditions, the availability of credit, the volume of trading activities and the Bank's perceived credit strength. These and other factors could limit the Bank's ability to raise funding in the capital markets, which could cause an increase in its cost of funding or could have other material adverse effects on the Bank's business. The Bank has demonstrated market access in both good times and when markets are more problematic, largely due to the Bank's more conservative and prudent approach to managing liquidity risk. Its liquidity strategy assumes that the Bank is able to fulfil regulatory requirements, internal thresholds and can sustain a prolonged period of stress. The Bank cannot guarantee that opportunities for funding or access to markets will be available or successful.

If the Bank fails to match the maturity profiles of its assets and liabilities or ensure that its funding grows in line with growth in its customer loan portfolio, the Bank will be exposed to a material risk that it may be unable to repay its obligations under its funding instruments when due, or will only be able to do so at excessive cost, which could have a material adverse effect on the Bank's position.

Further, the impact of COVID-19 in funding terms means that Standard & Poor's downgraded the main Icelandic banks by one notch to BBB/A-2 (stable outlook) from BBB+/A-2 (negative outlook) in April 2020 due to an expected drop in earnings. While the exact nature of this downgrade is difficult to quantify, it signifies the liquidity risks that may still prevail generally in Iceland as a consequence of the wider market, despite the Bank maintaining a strong liquidity position.

10. The Bank is exposed to operational risks

The Bank is reliant on processing complex transactions efficiently and accurately and therefore faces operational risks, such as systems failures, process errors, regulatory breaches and employee misconduct. Errors can happen when transactions are recorded and processed; for example, there can be miscalculations or a breakdown in internal controls. Given the volume of transactions the Bank processes, errors may occur multiple times before they are discovered and resolved, and there is no certainty that risk assessments made in advance will adequately estimate the costs of these errors. Errors or misconduct can have a particularly significant impact with respect to funds and portfolios managed by the Bank or its subsidiaries given the volume of assets under management in each fund.

The top priorities of the Bank in relation to operational risk as at the date of this Prospectus are outsourcing risk and information and communication technology (ICT) risk. According to the Bank's SREP results, as determined by the Central Bank of Iceland, operational risk accounted for 7.2% of total SREP capital requirement of the Group in 2020. The Bank has implemented controls designed to detect, monitor and mitigate operational risks. However, some risks can be challenging to identify, and the recommendations and suggestions of the Bank compliance and audit teams could be misunderstood and misinterpreted, which can weaken the effectiveness of the controls. The Bank is already subject to a high degree of regulatory scrutiny, and failings in the internal controls could cause enhanced scrutiny, financial losses and damage to the Bank's reputation.

11. The Bank is exposed to risk of failure and breaches of the Bank's information technology systems

All of the Bank's core banking systems have recently been renewed or replaced. The Bank's information technology ("IT") systems must be reliable, secure and perform strongly as they are central to the Bank's operations. The Bank's reliance on automated systems to record and process transactions makes it vulnerable to system outages or issues, equipment malfunction, natural hazards, interference by employees, computer viruses, cyber-attacks and unsuccessful IT system updates and implementation. These events could mean customers cannot access the Bank's services, leading to reputational damage for the Bank and potential claims from customers including breach of contract for customers seeking to recover significant damages they may incur as a result of a technology error, omission, malfunction or security breach. There is also the risk of theft of confidential information and fraud if the Bank is subject to cyber incidents, which have become increasingly sophisticated and could include, among others, unauthorised access, loss or destruction of data (including confidential client information), account takeovers, unavailability of service, computer viruses or other malicious code, cyber-attacks and other similar events.

The Bank has been subject to attempted and sometimes successful cyber-attacks from external sources in recent years, including denial of service attacks, which attempt to interrupt service to clients and customers; hacking and malicious software installations, intended to gain unauthorised access to information systems or to disrupt those systems; data breaches due to unauthorised access to customer account data; and malicious software attacks on customer systems, in an attempt to gain unauthorised access to the Bank's systems or customer data under the guise of normal customer transactions. There can be no assurance that any cyber incidents will not occur again, and they could occur more frequently and on a more significant scale.

The Bank's insurance policies may not cover the Bank fully for all losses that may occur as a result of these events. A sustained failure of the Bank's IT systems, or of critical third-party systems, would have a significant impact on its operations and the confidence its customers have in the reliability and safety of its banking systems and could therefore adversely impact the Bank's financial position.

12. The Group relies on third-party service providers

The Bank's operations are reliant on third-party service providers to supply a variety of services, technology and equipment that are central to significant portions of its operational and administrative processes, and is therefore exposed to the risk that external vendors may be unable to fulfil their contractual obligations to the Bank, or will be subject to the same risks of fraud or operational errors by their respective employees as the Bank is exposed to. The Bank is also exposed to the risk that its (or its vendors') business continuity and data security systems are inadequate. For example, the Bank relies on the Icelandic Banks' Data Centre, Reiknistofa bankanna ("**RB**"), for deposit account and payment infrastructure.

Third-party service providers are key for the running of the Bank's IT systems; for example, the Bank has an outsourcing arrangement in place for elements of operations with Advania. The Bank also relies on third-party service providers for other operations, including JCC in its cash centres, Borgun (currently known as SaltPay), MasterCard and RB with respect to card issuing and payment services. Whilst the Bank has contractual protections in place with third-party service providers, the Bank does not have much (if any) control over how the third-party service providers run their business. Accordingly, the Bank faces the risk that their third-party service providers become insolvent, enter default or do not or poorly perform their contractual obligations. Third-party service providers could also decide to terminate their relationship with the Bank, for example, as a result of an inability to provide the required services to the Bank due to restructuring, a change in strategic director or otherwise. The Bank may have to replace a third-party service provider on short notice which may be difficult if certain services are only available from a specific number of suppliers. Trying to find replacement service providers in a short timeframe or take other measures necessary to resolve problems could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations, particularly if the Bank suffers disruption as a result of the transfer of functions to the new provider. In addition, the Bank is subject to EBA guidelines No. 2019/02 on outsourcing agreements and FSA guidelines No. 1/2019 on risk related to the operation of information systems. Therefore, the Bank must also ensure that its service providers fulfil the relevant requirements.

There is also the risk that the Bank's third-party service providers fail to provide the products and services for which they have been contracted. They could lack the required capabilities, products or services or may be unable to perform their contractual obligations due to changes in regulatory requirements. Any failure of third-party service providers to deliver their contractual obligations on time or at all or their failure to act in compliance with applicable laws and regulations could result in reputational damage, claims, losses and damages to the Bank. The Bank seeks to control the risk with ongoing monitoring of performance, contractual terms, detailed requirements and external audit.

13. Unauthorised disclosure of confidential information and personal data, whether through cyber security breaches, viruses or otherwise could expose the Bank to fines, liabilities and costly litigation and damage in reputation

The Bank must be able to transmit confidential information in a secured way in order to carry out its operations. Given the Bank is a financial institution, it is subject to a heightened risk that it will be the target of criminal activity such as fraud, theft and cyber-attacks. The Bank processes: (i) personal customer data such as customer names, addresses, credit and debit card numbers and bank account details; (ii) merchant data such as merchant names, addresses, sales data and bank account details; (iii) transaction data, both within Iceland and internationally, such as payment instructions, money transfers, securities trading and various other electronic communications; and (iv) other confidential information as part of its business. It is therefore critical that the Bank safeguards this confidential information and comply with strict data protection and privacy laws in the applicable jurisdictions in which it operates, including through the Bank's subsidiaries. The Bank is exposed to the enhanced data protection requirements under the GDPR and could need to make additional changes to its operations, and potentially incur additional costs, in order to continually comply with the GDPR. Failure to comply with the GDPR could subject the Bank to substantial fines.

The Bank cannot be certain that its existing security measures will prevent security breaches or cyber-attacks. This is a risk to the Bank because it could be held liable should it lose control of confidential information or if it is accessed by unauthorised third parties through cyber-attacks, errors in software development or failings of the Bank to upgrade software, internal security breaches or by unauthorised personnel gaining physical access to confidential information. The Bank could also be subject to reputational damage and lose customers, and may suffer financial loss as a result of having to pay compensation to customers, any fines implemented by regulators and any damages awarded against the Bank in legal proceedings relating to a data breach.

The Bank requires third-party service providers to agree to confidentiality provisions restricting such third parties from using or disclosing any such confidential information when entering into a contract with the Bank. However, these provisions may not prevent the unauthorised use, modification, destruction or disclosure of confidential information or allow the Bank to seek reimbursement from the third-party in case of a breach of confidentiality or data security obligations. Any unauthorised use, modification, destruction or disclosure of confidential information could also result in protracted and costly litigation or administrative fines for the Bank. Any of these or other factors could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

14. Shortfalls in the Bank's risk management methods may leave it exposed to unidentified, unanticipated or incorrectly quantified risks, which could lead to material losses or material increases in liabilities

The Bank devotes significant resources to developing its risk management policies and procedures and expects to continue to do so in the future. However, there is a risk that the Bank's risk management strategies will not be fully effective in mitigating its risk exposure in all market environments and against all types of risk. The methods that the Bank uses to assess credit risk, market risk, liquidity risk, climate risk and operational risk may have limits. For example, some of the Bank's quantitative tools for managing risk are based upon historical market behaviour. These tools and metrics may not predict future risk exposures, and the Bank may be susceptible to losses which are significantly greater than its risk management measures indicate. In addition, new products and services that are offered through new digital channels, may impact the demographic composition of the Bank's customers. As a result, the Bank's current risk models might not be applicable and new risk factors might not be detected in a timely manner.

The risk management procedures the Bank has implemented may not be understood or communicated properly to employees. The procedures may therefore not be implemented correctly. In addition, because the Bank's risk management policies are under regular review, there could be a time lag between review and the implementation of updates. Unanticipated or incorrectly quantified risk exposures, and poor implementation of the risk management procedures, could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

15. The Bank relies on key members of management

The Bank is highly dependent on the talent of its key personnel, in particular its Chief Executive Officer and senior management, many of whom have been employed by the Bank for a substantial period of time and have developed alongside the Bank. The loss of key members of its senior management or staff may significantly delay the Bank's ability to implement its strategies and could have a material adverse effect on its business, financial condition and results of operations. In addition, there is competition between businesses in Iceland, which can hinder the Bank's ability to recruit and retain new senior managers if competitors of the Bank are able to offer more competitive salaries and better incentivise individuals.

The managing directors for individual business and support divisions are responsible for the operational risk inherent in their business. This entails identifying the sources of operational risk in their operations, assessing whether the cost of avoiding the risk outweighs the benefits and ensuring that unacceptable operational risks are mitigated, and losses prevented. Due to the highly skilled nature of performing such tasks, there is an inherent risk to the proper functioning of the Bank's operations should certain members of management leave the Bank and suitable replacements are difficult to source. This creates an exposure for the Bank in such circumstances, as risk management is critical to monitoring the overall operational risk profile of the Bank, ensuring proper escalation and reporting of operation risk issues and providing independent views on the overall operation risk inherent in the Bank's operations.

16. Public sentiment and political activity in Iceland could impair the Bank's operations

Due to the financial crisis in 2008 and the subsequent deep recession in Iceland, public sentiment towards the banking sector has at times been negative. Any such negative sentiment could ultimately be reflected in political and legislative decisions which could have material adverse effects on the Bank.

In addition, various decision-making processes within the Bank may continue to be affected by perceived public sentiment and reputational risk due to the financial crisis in 2008 and the resulting lack of trust in the banking sector. This could, for example, lead to the Bank deciding to refrain from engaging in activities which it might otherwise consider to be in its interests and the interests of its shareholders, such as whether to divest or otherwise restructure any of its operations, provide credit to a particular borrower or hire the best qualified individual for a job because of their association with or involvement in events leading up to or in the aftermath of the financial crisis.

During the financial crisis, the Icelandic government was not able to provide liquidity and guarantees to the banking sector, mostly due to the size of the banking sector before 2008. It is unclear whether, and in what capacity, the Icelandic government would assist the banking sector during difficult times in the future.

Any negative public sentiment in Iceland relating to the Bank's shareholders and other stakeholders, including professional financial and institutional investors, could also lead to a loss of customers or business opportunities for the Bank.

Moreover, even if the Bank's operations are otherwise successful and it is in a position to declare and pay a dividend in the ordinary course, the Bank's ability and willingness to declare and pay dividends, whether as a requirement of law or otherwise, may be affected if public sentiment opposes the payment of dividends, even in the event the Bank is legally permitted to pay dividends. See "*—Risks Relating to the Offering and the Offer Shares—The Bank's ability to declare a dividend in the future is subject to a variety of factors*".

17. The Bank relies on its reputation and brands and those of its subsidiaries

The success of the Bank's business depends significantly on the Bank's reputation with customers as well as the strength and appeal of the brand of the Bank. The Bank's reputation is one of its most important assets and its ability to attract and retain customers and staff and conduct business with its counterparties could be materially adversely affected to the extent that its reputation or the reputation of its brand is damaged. Failure to address, or perception that the Bank has failed to address, various issues that could give rise to reputational risk could cause harm to the Bank and its business prospects. Reputational issues could include:

- poor customer service or IT failures or interruptions that impact customer services and accounts (see "*— The Bank is exposed to risk of failure and breaches of the Bank's information technology systems*");
- failure, or allegations of having failed, to maintain appropriate standards of customer privacy, customer service and record keeping and disclosure of confidential information (see "—Unauthorised disclosure of confidential information and personal data, whether through cyber security breaches, viruses or otherwise could expose the Bank to fines, liabilities and costly litigation and damage in reputation");
- failure to appropriately address potential conflicts of interest and acting, or allegations of having acted, unethically in the conduct of its business;
- breaching, or allegations of having breached, legal and regulatory requirements, including anti-money laundering and anti-terrorism financing requirements (see "—Legal and Regulatory Risk— The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities " and "—Legal and Regulatory Risk—The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences");
- failure to properly identify legal, regulatory, compliance, reputational, credit, operational, liquidity and market risks inherent in the Bank's products and services (see "— The Bank is exposed to a range of other typical financial institution market risks, including interest risk and equity price risks as well as inflation risk " and "—The Bank is exposed to operational risks");
- third parties on whom the Bank relies for information, products and services failing to provide the required information, products and services;
- adverse impacts on customers of the Bank which had invested in or had exposures to companies whose loans are determined by the Bank to be non-performing loans, and experienced losses as a result; and
- generally poor business performance.

Failure to address these or any other relevant issues appropriately could damage the Bank's reputation and make customers, depositors and investors less willing to do business with the Bank, which may have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

In addition, the Bank believes that its brand and the brands of its subsidiaries Iceland Funds and Ergo are one of the key differentiators from competitors and provide a key competitive advantage. However, no assurance can be given that the Bank and its subsidiaries will be successful in further developing their respective brands and leveraging them into market share growth over competitors. Any circumstance that causes real or perceived damage to the Bank's brand or the brands of its subsidiaries, including the occurrence of any of the risks or events described in these "*Risk Factors*", could have a material adverse effect on the Bank's ability to retain existing customers and attract new customers. An inability by the Bank or its subsidiaries to manage the risks to their brands could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

18. The Bank may be unable to successfully implement its strategy or achieve its financial targets, or its strategy may not yield the anticipated benefits

The Bank's strategy and financial targets are based on assumptions and expectations, including in respect of macroeconomic developments, competition, interest rates, revenue, expenses and cost of risk and future demand for Bank's services, which may prove to be incorrect. Also, the benefits and impact of the Bank's strategy could fall short of what the Bank anticipates. For example, the Bank might not be able to realise the full benefits of its further cost-savings or digital initiatives, which could result in less than expected customer satisfaction improvements and cost reductions and negatively impact revenues and operating results. For additional information on the Bank's strategy, see "*Business Overview—Strategy*".

Since the global financial crisis in 2008, macroeconomic volatility has made it more difficult to predict GDP development in many economies, resulting in frequent modifications to growth expectations published by economic research institutions as well as in adjustments by market research specialists, sometimes giving rise to significant revisions to growth expectations for specific markets. As a result, many financial institutions, including the Bank, may find it difficult to accurately model and predict the prospects for their businesses and set viable financial targets, and it may be difficult for investors to use historical financial results as an indicator for future results. Any failure by the Bank to accurately predict macroeconomic developments, interest rates, revenue, expenses and cost of risk and/or future demand for Bank's services could lead to misjudgements with respect to its strategy or financial targets and increase the risk of failed implementation or failure to achieve any of its targets. If the Bank's strategy or is not implemented successfully, if the Bank fails to achieve its financial targets, or if the Bank's strategy does not yield the anticipated benefits, this could have a material adverse effect on the Group's business, prospects, financial position and/or results of operations.

19. The determination of the amount of allowances and impairments taken on the Bank's assets requires a degree of management judgement, and the incorrect determination of such allowances and impairments could have a material adverse effect on its business, results of operations, financial condition and prospects

The Bank's business requires management to develop models and apply judgement and assumptions which may prove incorrect. The determination of the amount of allowances, provisions and impairments under the Bank's accounting principles and policies with respect to certain assets vary by type and is based upon the Bank's periodic evaluation and assessment of known and inherent risks associated with the respective asset class. Such judgements also apply to other financial items such as goodwill and deferred tax assets. In considering impairments, management considers a wide range of factors and develops scenarios using its best judgement in evaluating the cause of the decline in the estimated fair value of the security or cash-generating unit and the prospects for near-term recovery, including probability of default. For certain asset classes, in particular in respect of loss provisioning for its residential mortgages and other loans, management's evaluation involves a variety of assumptions and estimates about operations and future earnings potential and relies heavily on the official tax evaluation of immovable property. To the extent that the Bank needs to take any additional impairments and/or allowances, it could have a material adverse effect on the Bank's business, results of operations, financial condition and prospects.

20. The Bank's insurance coverage may not adequately cover losses resulting from the risks for which it is insured

The Bank maintains customary insurance policies for the Bank's operations, including insurance for liquid assets, money transport and directors' and officers' liability. The Bank's business involves risks of liability in relation to litigation from customers, employees, third-party service providers and action taken by regulatory agencies, and there is a risk that these may not be adequately covered by the insurance or at all. Due to the nature of the Bank's operations and the nature of the risks that the Bank faces, there can be no assurance that the coverage that the Bank maintains is adequate which could have a material adverse effect on the Bank's operations and financial condition.

21. The Bank may be unable to recruit or retain experienced and qualified personnel

The Bank needs qualified and experienced banking and management personnel in order to succeed and the ability to attract, train and motivate highly qualified personnel is key to the Bank's strategy. There is a lot of competition from both financial and non-financial services companies for experienced personnel, given Iceland's relatively small population. Particularly at senior levels, the Bank may not be able to offer the rates of compensation which are offered by larger international institutions or even smaller domestic competitors (which may be able to offer more flexible compensation plans), because the Bank may be restricted by law or to some extent by public opinion. The loss of employees with knowledge of the industry and customers could have a negative impact on the Bank's success.

22. The Bank is subject to the risk of labour disputes, work stoppages and increased labour costs

Most of the Bank's employees are represented by the Confederation of Icelandic Bank and Finance Employees. Although the Bank believes that its relations with its employees and with the Confederation of Icelandic Bank and Finance Employees are generally good, there can be no assurance that this will continue to be the case. A deterioration of relationships between the Bank and its employees and the Confederation of Icelandic Bank and Finance Employees could result in strikes or work stoppages. In addition, the Bank's relations with employees represented by the Confederation of Icelandic Bank and Finance Employees are governed by certain collective bargaining agreements and the Bank may not be able to renegotiate satisfactory collective bargaining agreements when they expire, which could lead to, among other consequences, increased labour costs. Such renegotiation could also lead to disputes which may disrupt the Bank's operations. Any sustained labour dispute leading to a substantial interruption in the Bank's overall business, increased labour costs or changes to the terms of collective bargaining agreements could have a material adverse effect on the Bank's business, financial condition and results of operations.

23. The Bank may be subject to consequences due to mildew in former headquarters

The Bank's former headquarters at Kirkjusandur has been deemed unfit for habitation and other use due to mildew. In 2016, the Bank requested a building assessment and evaluation from EFLA consulting engineers regarding the indoor air quality of the building due to health-related issues of the employees of the Bank. During the assessment, it was revealed that serious faults are in the build-up and finishing of the building envelope. Samples of moisture-damaged building materials confirmed mould and/or bacterial growth. Approximately one-quarter of the Bank's employees were examined and most of them showed symptoms of illness that could be related to the moisture damage, bacteria and mould. Based on the findings from the assessments, sampling and research, EFLA could not recommend future use of the building without major renovation and recommended relocating the employees as soon as possible. EFLA concluded that it would be more efficient and safer to demolish the building as any sale or renting of the building could impose severe health risk to potential occupiers. The Bank moved its headquarters from Kirkjusandur to current location at Norðurturn in the autumn of 2016, but the property is still owned by the Bank. Current and former employees of the Bank, who have suffered health problems due to the working conditions of the Bank prior to 2016, may seek damages from the Bank for incapacity for work and personal injury. The general limitation period for such claims is 10 years but may be extended in circumstances provided for in Act No. 150/2007 on limitation periods for claims.

Risks Relating to Macroeconomic and Other Business Conditions

1. The strength of the Icelandic economy remains vulnerable to a range of domestic and international economic and political factors

Almost all of the Bank's business is conducted in Iceland, therefore its performance is influenced by business activity in Iceland and the strength of the Icelandic economy. Iceland's economy is influenced by economic and political factors on both a domestic and international scale. Iceland's economic growth has fluctuated recently, with GDP growth of 4.2% in 2017, 4.7% in 2018, 2.6% in 2019, and a decrease of 6.6% in 2020 (*source: Statistics Iceland*). As a small, open economy, the strength of the Icelandic economy will always be susceptible to fluctuation.

There are various domestic factors that could impact the health of the Icelandic economy:

- *Fluctuations in the value of the Icelandic Króna*: In 2020, Icelandic Króna depreciated by 4.0% against the U.S. dollar and 12.6% against the Euro. There is a risk if there is a further depreciation of Icelandic Króna, as an increase in the cost of imports could weaken consumer confidence and cause a decline in certain sectors, such as real estate. On the other hand, a large appreciation in the value of the Icelandic Króna could reduce the demand for Icelandic exports or services, including tourism, and could make Iceland less competitive than other economies and currencies.

- *Inflation*: While inflation is currently above the target rate of 2.5% per year set by the Central Bank of Iceland, the outlook is that the rate of inflation could reach the target by the end of year 2021 (*source: Central Bank of Iceland*). However, a combination of considerable increases in housing prices, rapid wage increases, and a further depreciation of the Icelandic Króna could result in a more persistent inflation pressure.

- *Lack of foreign direct investment*: There is no guarantee that there will be sufficient levels of foreign direct investment in Iceland, which may cause fiscal and balance of payments deficits and weaken Iceland's economic and fiscal position.

- *Other factors*: Other domestic factors, such as political instability and public opinion (particularly surrounding public opinion of the financial sector) as well as levels of consumption, pose as significant risks for Iceland's economy.

Iceland's economy is also vulnerable to external factors outside of its control; for example, European and international politics. Given its size and the openness of the economy, Iceland is highly dependent on trade with external partners such as the European Union, therefore events such as the United Kingdom's exit from the European Union, and any consequential economic and political effects that exit has, could have a material adverse effect on Iceland's economy. The financial sector in Iceland is still nominally subject to the Capital Controls and is largely funded by domestic deposits. Also, a global recession is likely to have an impact on the demand for, and the price of, Iceland's most important products and exports (such as tourism and seafood).

The occurrence of any of the above factors could adversely affect Iceland's economy, which in turn could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

2. COVID-19 has had, and may have further, adverse impacts on the Bank

The impact of COVID-19 on the Bank's business and industry is significant, and its effects will continue to create uncertainty in the market and materially impact the Bank's business, financial condition and results of operations for the foreseeable future due to many factors, most of which are beyond the Bank's control.

In late 2019, a new strain of coronavirus (severe acute respiratory syndrome coronavirus 2 or SARS-CoV-2), which can cause coronavirus disease (COVID-19), was detected in Wuhan, China. In March 2020, the World Health Organization declared COVID-19 a global pandemic and governmental authorities around the world implemented measures to reduce the spread of COVID-19. For example, in March 2020, Iceland imposed the first set of significant lockdown measures to control the spread of COVID-19. These measures to stop the spread of COVID-19 have adversely affected workforces, customer sentiment, economies and financial markets, and, along with causing overall decreased customer spending and widespread uncertainty following months of lockdowns and related uncertainty, have led to an economic downturn in Iceland and have had a direct impact on the Bank's business. COVID-19's impact on the Bank's borrowers and their industries has already had and could also have in the future a material adverse effect on the Bank's financial results, businesses, financial condition or liquidity and the ability of borrowers to pay their loans. COVID-19 may also result in disruption to the Bank's key suppliers of goods and services and result in increased unavailability of staff adversely impacting the quality and continuity of service to customers and the reputation of the Bank. As a result, the business, results of operations, corporate reputation and financial condition of the Bank could be adversely impacted for a substantial period of time.

Resurgences, or waves, of COVID-19 are likely to occur. The Bank cannot predict when or where these waves will occur, the duration of such waves or how far into the future such waves will continue to occur, nor can it predict with any certainty the impacts of such subsequent waves, including the impacts of future national or local lockdowns or other measures implemented by national and/or local authorities. If COVID-19 is prolonged, or further diseases emerge that give rise to similar effects, the adverse impact on the global economy could deepen and result in further declines in financial markets.

In response to COVID-19, the Bank has transitioned a significant number of its employees to a remote work environment, in an effort to mitigate the spread of COVID-19, which may exacerbate certain risks to the Bank's business. To the extent that a portion of the Bank's workforce cannot work remotely, the Bank cannot be certain that the measures it has taken can fully mitigate the risks posed to them by COVID-19, and the Bank could be subject to potential litigation as a result of employees alleging that the Bank facilitated an unsafe working environment or increased their exposure to COVID-19, or employees who claim they have contracted the virus on the Bank's premises, which may cause the Bank to incur significant costs and which may have a negative impact on its brand and reputation. All of these risks may be further exacerbated by resurgences of the virus.

The consequences of COVID-19 have already been great and have affected the overall economic climate in Iceland as well as individuals and companies. In order to respond to this, the government has implemented new laws and regulations as well as amendments. The legislations that have primarily affected the Bank's operations are the legislations on support loans and financial support to smaller companies. In response to COVID-19, the Central Bank of Iceland has taken a wide range of actions, including lowering interest rates, boosting domestic financial institutions' access to capital, using the international reserves to mitigate exchange rate volatility and commencing secondary market purchases of treasury bonds.

In addition to the factors listed above, COVID-19 and the measures taken to respond to it have created an environment of uncertainty and rapid, unpredictable changes that exacerbates and magnifies certain of the other risks the Bank faces. The effect of COVID-19 on the Bank's business and industry will ultimately depend on a number of factors, including, but not limited to, the duration and severity of the pandemic in Iceland and globally, the length of time it takes for demand to return to previous levels and for previous economic and operating conditions to resume and the potential for, and uncertainty surrounding, virus resurgence. There are no comparable recent events that provide guidance, and so it is not possible yet to know the full impact of COVID-19 on the Bank's business with any certainty, nor can the Bank provide any assurance that COVID-19 will not have a material adverse effect on the Bank's business, financial condition and results of operations in the future. To the extent COVID-19 impacts the Bank's business, financial condition and results of operations, it may also have the effect of heightening the other risks described in this "Risk Factors" section.

3. Systemic risk could adversely affect the Bank's business

Concerns about, or a default by, one financial institution could lead to significant liquidity problems, losses or defaults by other financial institutions because the commercial soundness of many financial institutions may be closely related as a result of credit, trading, clearing or other relationships between these institutions. This risk is sometimes referred to as "systemic risk" and may materially affect financial intermediaries, such as clearing agencies, clearing houses, banks, securities firms and exchanges with which the Bank interacts on a daily basis, and could materially affect the Bank's business operations and results.

Systemic risk of the global financial industry is still at an elevated level. High sovereign indebtedness, low capital levels at many banks and the high interconnectivity between the largest banks and certain economies are important factors that contribute to this systemic risk. Against this backdrop of the financial crisis, during which the lack of liquidity and high costs of funding relative to official rates in the interbank lending market reached unprecedented levels, the Bank is subject to the risk of deterioration of the commercial weakness or perceived weakness of other financial institutions within and outside Iceland. Concerns about or a default or threatened default by one institution have affected and may in the future affect the banking system and lead to significant market-wide liquidity problems and financial losses at many financial institutions including the Bank.

The Bank is exposed to counterparty risk as a result of financial institution failures and nationalisations and will continue to be exposed to the risk of loss if counterparty financial institutions fail or are otherwise unable to meet their obligations. This risk is particularly pronounced in the clearing business of the Bank. A default by, or even concerns about a default by, one or more financial services institutions could lead to significant systemic liquidity problems, or losses or defaults by other financial institutions, which could have a material adverse effect on the Bank's liquidity, results of operations, financial condition and prospects.

4. The Bank is exposed to climate-related risks

The Bank is exposed to climate-related risks in connection to its lending and investment activities, particularly given Iceland's geographical location. Climate-related risks consist of two major categories that are often called transition risks and physical risks. Transition risks include policy, legal, technology, reputational and market changes due to adoption of new requirements related to climate change and a transition to a low carbon economy. Physical risks are related to physical impacts of climate change such as extreme weather and long-term shifts in sea temperature and acidity.

Transition risks can disrupt the business models of the Bank's customers due to changes in demand for products and services. The expectation of impending changes in demand may also drive business decisions, and in sectors where this does not happen organically, tax incentives and disincentives are likely to play a role. For example, during the transition towards cleaner energy in the transport sector, tax incentives are expected to be given for cars which use cleaner energy, whereas carbon tax may be significantly increased.

The Bank's customers are exposed to physical risk related to climate change, for instance in the seafood industry where the availability of fish and shellfish might diminish due to temperature and acidity changes in the ocean around Iceland. Physical risks can have a direct financial impact through damaged assets and supply chain disruptions. As awareness of the potential impact increases, exposed assets are liable to fall in value and increase insurance premiums. Supervisors have been directing attention to climate risk globally and its effect on financial stability, and in some places countrywide climate risk stress tests have been planned. The Bank has started to perform exploratory climate stress tests scenarios against its portfolio. The aim of the analysis is to identify which sectors of the Bank's portfolio may have high adverse impacts on the environment and in which the Bank has a significant number of customers. The sectors are then further analysed in comparison to the Climate Action Plan of the government of Iceland. Any of the foregoing climate-related risks could have a material adverse effect on the Bank's liquidity, results of operations, financial condition and prospects.

5. Iceland's banking system has been subject to restructuring and is relatively small given the small size of the Icelandic economy, which could limit opportunities for growth in the near term

The small size of the Icelandic economy and any changes to the Icelandic banking sector have affected and could continue to affect the Icelandic banks. Uncertainty about the quality of the loan assets held by the Bank, Arion Bank and Landsbankinn and the relatively high levels of non-performing loans on their balance sheets were historically a risk to the business, prospects, financial position and/or results of operations of the Icelandic banks. Although the levels of non-performing loans on the balance sheets of the Bank, Arion Bank and Landsbankinn have declined from 42% of total loans as at 31 December 2009 to 2.2% as at 31 December 2020 *(source: Central Bank of Iceland)*, no assurance can be given that the rate of non-performing loans will not increase in the future. Levels of non-performing loans, determination of loan values and the levels of write-offs will depend, in the medium term, on general economic developments and on the operating and financial condition of the particular borrowers as well as decisions by the Supreme Court of Iceland affecting the value of loans linked to foreign currencies. Worldwide financial and economic developments, in particular financial and economic developments in the United Kingdom and the other European countries that constitute Iceland's main trading partners, may also have an effect.

Given the relatively small size of the Icelandic economy and the short period of time since the financial crisis in 2008, Icelandic households and businesses may be reluctant to engage in new borrowing activities and, as a result, the Icelandic banks may experience increased competition and consequently pressures on net interest income. In addition, the Bank has limited funding opportunities in Icelandic Króna, namely its ISK-denominated deposits, its senior unsecured bonds and its covered bond and domestic bond programmes, none of which are capable of fully funding the Bank's ISK corporate lending volumes. Consequently, the Bank's ability to increase its corporate lending is limited and will continue to be limited unless the Bank is able to find additional sources of funding in Icelandic Króna. It is also unlikely that the Bank, Arion Bank or Landsbankinn will grow significantly through international operations in the near future. Iceland's economy remains vulnerable to renewed disruptions, cessation or reversal of growth and a return to recession. Moreover, the Icelandic banks could also be adversely affected if other developments in the Icelandic economy or internationally result in slowing of growth in Iceland's economy or trigger a recession, any of which could in turn have a material adverse effect on the Bank's business, financial condition, results of operations or prospects.

6. Catastrophic or unforeseen events such as acts of war, acts of terrorism, earthquakes, floods, other natural disasters, pandemic diseases or other geopolitical events may have a material adverse effect on the Bank

Catastrophic or unforeseen events, such as acts of war, acts of terrorism, earthquakes, volcanic eruptions, floods, other natural disasters, pandemic diseases or other geopolitical events, and the subsequent responses to such events, may cause socio-economic and political uncertainties which may have a negative effect, directly or indirectly, on the economic conditions in Iceland and could result in substantial losses being suffered by the Bank. Such events and the losses and damage which may result are difficult to foresee and may relate to property, financial assets, data storage facilities, trading positions or key employees.

If the Bank's security, response and business continuity plans do not fully address such events or cannot be adequately implemented, such losses may increase. Unforeseen events may also lead to additional operating costs, such as higher insurance premiums. Insurance coverage for certain catastrophic or unforeseen events may also be unavailable or excluded from existing policies held by the Bank, and thus increase the risk to which the Bank is exposed.

Moreover, the Iceland's economy is vulnerable to the effects of certain natural disasters, such as earthquakes and volcanoes, which have occurred in certain regions in recent years, as well as other forms of destructive weather. Deterioration in the investment environment and investment inflows as a result of domestic or external conditions, including adverse tax conditions, natural disasters, increased corruption, or weakened investor sentiment, could also limit future growth prospects. The occurrence of any catastrophic or unforeseen events may have a material adverse effect on the Bank's business, financial condition, results of operations, cash flows or prospects.

Risks Relating to the Business Model and the Ownership Structure of the Bank

1. The Bank, its operations and its management may continue to come under the public spotlight from time to time for as long as the Icelandic state has an ownership interest in the Company

The Icelandic state, through the Selling Shareholder, will remain a major shareholder of the Bank for the foreseeable future and as a result, the Bank, its operations and its management will continue to occupy the public spotlight and be subject to public scrutiny from time to time. It cannot be excluded that in the future, the Bank will be in the public spotlight and come under pressure to change aspects of its corporate governance, policies and certain operations or to review past practices. This may force the Group to spend potentially significant amounts of management time and incur significant expense.

2. Further reductions of the Icelandic state's interest in the Bank may result in a perception of increased risk by investors and customers, including depositors

Immediately after the closing of the Offering, the Icelandic state, through the Selling Shareholder, will hold 71.5% of the Bank's share capital, assuming that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised (68.7% if the Over-Allotment Option is exercised in full). Although the Selling Shareholder will agree with the Managers not to divest its remaining Shares for a period of 180 days after the first day of trading in the Offer Shares on Nasdaq Iceland, this lock-up is subject to certain exceptions, and in any event the timing and the form of any further offerings of Shares by the Selling Shareholder are uncertain. Such sales may result in a perception of increased risk by investors, counterparties and clients, including depositors, with respect to the safety of customer deposits, the Bank's capital position, risk profile and the Bank's soundness in general as some investors and customers may have taken comfort from the Icelandic state's shareholding in the Bank. This could lead to a general decrease in investor, counterparty and customer confidence, which may, for example, result in a reduction of customer deposits. The materialisation of any of these events could materially and adversely affect the market price of the Bank's securities and its business, financial condition and results of operations.

3. Disruptions, dislocations, structural challenges and market volatility in financial markets could materially and adversely affect the Bank's banking and funding activities and could materially and adversely affect the Group's business, financial condition, results of operations and prospects

Financial markets can experience, sometimes sustained, periods of unpredictable movements, severe dislocations, liquidity disruptions and economic shocks. These market conditions could lead to volatility in the Bank's profitability and in (the composition of) its balance sheet caused by price changes and changes in the demand for some of the Group's banking services and products. Such conditions could have a material adverse effect on the Bank's business, results of operations, financial condition and prospects. These market conditions may also impede the Bank's ability to sufficiently and timely raise funding and capital. This could result in, among other things, a delay in raising funding or capital, the issuance of capital and funding of different types or under different terms than otherwise would have been issued or realised, or the incurrence of additional or increased funding and capital costs compared to the costs borne in a more stable market environment. Furthermore, the Bank's hedging and other risk management strategies, such as balance sheet steering and interest rate management, may not be as effective at mitigating risks as such strategies would be under more normal market conditions. This could potentially lead to a decrease of the Bank's profitability, financial condition and financial flexibility.

Financial markets are susceptible to severe events characterised by rapid depreciation in asset values accompanied by a reduction in liquidity. Under such conditions, market participants are particularly exposed to the market behaviour of market participants simultaneously thereby on a large scale unwinding or adjusting positions, which may even further exacerbate rapid decreases in values of the Bank's assets or collateral held in its favour and which could cause liquidity tensions and disruptions. These market conditions may cause a decline in the profitability, an increase in unrealised losses in the Group's various (asset) portfolios, and a reduction in unrealised gains in the Bank's various (asset) portfolios.

The economies in which the Group is active may continue to face structural challenges, which could contribute to renewed high volatility in both the debt and the equity markets. Any deterioration of the sovereign debt market in the Eurozone or elsewhere, or other economic shocks could materially and adversely affect the Bank's results of operations, financial condition and prospects, as well as the Bank's funding and capital transactions and hedging and other risk management strategies. Other events may also affect the financial markets, such as heightened geopolitical tensions, war, acts of terrorism, natural disasters or other similar events.

There is no assurance that market volatility will not result in a prolonged market decline, or that such market declines for other reasons will not occur in the future. Severe market events have historically been proven to be difficult or impossible to predict, and could lead to the Bank realising significant losses, especially if they were to persist for an extended period of time. Therefore, market volatility, liquidity disruptions, or market dislocations could materially and adversely affect the Bank's banking, capital and funding activities and could have a material adverse effect on the Bank's business, financial condition, results of operations and prospects.

Legal and Regulatory Risk

1. The Bank is subject to capital requirements and related regulations, which impose costs and may result in legal actions against the Bank

The Bank's capital management framework is based on CRD IV and CRR, which were largely already implemented into Icelandic legislation. For more information on the Bank's capital requirements, see "*Regulatory Overview — Principal Legislation and Regulations — Capital Requirements Directive*".

The pending implementation of the remaining features of CRD IV into Icelandic legislation could limit the Bank's ability to effectively manage its capital requirements. These and other changes to capital adequacy and liquidity requirements imposed on the Bank may require the Bank to raise additional Tier 1, core Tier 1 and Tier 2 capital by way of further issuances of securities and could result in existing Tier 1 and Tier 2 securities ceasing to count towards the Bank's and/or the Group's regulatory capital, either at the same level as present or at all. These and other changes to capital adequacy and liquidity requirements imposed on the Bank may also negatively impact the Bank's ability to pay dividends. Furthermore, the Bank is subject to stress testing, which may result in a requirement to raise additional capital or more stringent capital requirements in the future.

Any failure by the Bank to maintain any increased regulatory capital requirements or to comply with any other requirements introduced by regulators could result in intervention by regulators or the imposition of sanctions, which may have a material adverse effect on the Bank's profitability and results and may also have other effects on the Bank's financial performance and on the pricing of the Shares, both with or without the intervention by regulators or the imposition of sanctions.

2. The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages

The Bank is subject to basic corporate income tax rate of 20%. However, the Bank is subject to several further taxes which apply to financial institutions in Iceland. These taxes increase the Bank's effective cost of funding, which can hinder its ability to compete effectively with lenders who are not subject to these taxes.

The Bank pays a significant amount of taxes in Iceland. The Bank pays corporate income tax, the Bank Levy, the Special Financial Activity Tax, and the Financial Activity Tax amounting to ISK 6,137 million in 2021 compared to ISK 7,372 million in 2020. The decrease between years is mainly due to a decrease in the Bank Levy. (Taxes paid in 2020 are not fully comparable to paid taxes according to the Statement of Cash Flows in the Annual Financial Statements for the year ended 31 December 2020 since the Statement of Cash Flows does not include the Financial Activity Tax and changes in the previous year's taxes.)

The Bank Levy is an annual levy mandated by Icelandic law under which the Group must currently pay a tax on total liabilities, as determined for tax purposes (excluding tax liabilities), in excess of ISK 50.0 billion. The Bank Levy for 2020 was calculated as 0.145% on the total liabilities of the Bank in excess of ISK 50.0 billion. Non-financial subsidiaries are exempt from the Bank Levy. Whilst the Bank Levy was initially introduced in 2010 as a temporary measure there is no certainty as to whether it will be lowered, removed or increased going forward. The Financial Activity Tax is a 5.5% tax levied on all remuneration paid to employees. Under the Special Financial Activity Tax Act, the Bank is also subject to the Special Financial Activity Tax, calculated as 6% of taxable profit exceeding ISK 1.0 billion. The Bank Levy, the Financial Activity Tax and the Special Financial Activity Tax put the Bank at a competitive disadvantage to lenders who do not have to pay those taxes, such as international banks, domestic pension funds and the Housing and Construction Authority.

In addition, there is the risk that there could be increases to the tax the Bank has to pay, and the tax authorities could refuse to issue or extend advanced tax rulings. The unavailability of tax rulings could also restrict the range of structured transactions the Bank can enter into with its customers. Additionally, further taxes or levies could be introduced in the future. Any additional tax or levy could increase the Bank's cost of funding and operating costs generally, impair the ability of the Bank to compete effectively with other lenders and/or decrease the Bank's lending volumes and margins and reduce the Bank's profitability.

3. The Bank could face tax liabilities or competitive disadvantages in respect of VAT on some of its services

The services of banks, savings banks and other credit institutions are currently exempt from value added tax ("**VAT**") under the Value Added Tax Act No. 50/1988. The tax authorities in Iceland have historically construed the exemption to be limited to the services that banks and other credit institutions provide according to the Financial Undertakings Act. For certain of the services provided by the Bank to customers, the Bank has not historically collected VAT, and there is uncertainty whether VAT should be collected for some of such services. While the Bank believes that its practices with respect to collection of VAT are common among financial institutions in Iceland, there can be no assurance that Icelandic tax authorities will not reassess VAT on services provided by the Bank and conclude that the Bank has failed to collect VAT properly on certain services in the past based on a stricter interpretation of the exemption provided in the Value Added Tax Act. Should this occur, the Bank could be liable retroactively for six years' unpaid amounts, plus penalties and interest. To the extent that, going forward, the Bank decided, or was obliged, to start claiming VAT in respect of such services but its competitors did not, it would be at a competitive disadvantage and could be priced out of competing effectively for provision of certain services. Any of the foregoing could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

4. Regulatory changes or enforcement initiatives could adversely affect the Bank's business

Due to the sectors in which the Bank operates, all operations involve a significant regulatory and legal risk, and the Bank is subject to substantial laws and regulations. The legal and regulatory environment of the Bank is constantly changing, and the Bank puts substantial resources into monitoring and implementing these changes to ensure full compliance. The Bank and its subsidiaries face the risk that the Icelandic authorities will adopt further applicable regulations and that legislation will be brought in with more stringent requirements than under current EU regulations and directives, for example, with respect to capital requirements. Changes to the laws, regulations and policies could happen at any time and are difficult for the Bank to predict. Changes could materially affect the way in which the Bank conducts its business, the products or services it may offer and the value of its assets. Additionally, if the Bank does not react to the changes quickly or appropriately, its reputation could be damaged and it could be subject to legal proceedings, enforcement actions, fines and/or penalties.

The Bank and its subsidiaries are also subject to regulatory scrutiny from certain supervisory bodies, such as the FSA, the ICA, the DPA and the Consumer Agency, which have broad administrative powers over many aspects of the Bank's business. See "*Regulatory Overview—Principal Governmental Authorities*". The Bank requires licences issued by the FSA in order to carry out many of its operations. It may take considerable resource to comply with the licences, or to comply with new or revised laws, administrative decisions or supervisory guidance. Violations of rules and regulations, whether intentional or unintentional, or failure to comply with licensing or other requirements, may adversely affect the Bank's reputation or financial condition, results of operations and prospects.

In addition, existing laws and regulations could be amended, the manner in which laws and regulations are enforced or interpreted could change and new laws or regulations could be adopted in ways unfavourable to the Bank's operations, which could adversely affect the way the Bank operates its business and its market reputation. See "*Regulatory Overview—Principal Legislation and Regulations*" and "*—Proposed Legislative Amendments*". For example, the Bank could incur significant costs and it could be required to make changes to its operations and management. Failure to comply with any of the above could expose the Bank to civil or criminal liability, reputational damage and sanctions, such as fines, having its licences, authorisations or permits revoked and put the Bank under closer regulatory scrutiny.

Similarly, Iceland has adopted (or is in the process of adopting) the European framework for bank surveillance which aims to improve the strength and stability of the financial system and made other legislative and regulatory changes. See below and in "*Regulatory Overview—Principal Legislation and Regulations*" and "*—Proposed Legislative Amendments*".

- It has been proposed that a new Act on Payment Services transposing the Payment Services Directive 2 enter into force on 1 July 2021 in Iceland. The delegated EU Regulation 2018/389 on strong authentication and secure communication is expected to enter into force as soon as the new Act passes on 1 July 2021 (although implementation will not take place until 10 January 2022). This means that the Bank must have a testing facility by the time the Act enters into force.

- Further, it has been proposed that the Interest Act will be amended such that the index-linked annuity loans can only be granted for 10 to 25 years (currently 5 to 40 years) however with certain exceptions concerning the age and financial status of the borrower. If the bill is approved, it will restrict certain type of credit that has been in demand for several years and may lead to changes in the composition of new loans.

- There were notable regulatory changes in 2020 which the Bank must comply with, brought in through Act No. 70/2020 on the resolution of credit institutions and investment firms. This Act implements the second part and main body of the BRRD. One of the two main objectives of the Directive is to prevent difficulties in the operation of financial undertakings. To achieve this objective, undertakings that fall within the scope need to take preventive and preparatory measures in order to respond to difficulties. Secondly, the aim is to minimise the negative consequences of a potential financial crisis by securing the government's authority to intervene in the operations of companies that are financially unstable. With the implementation of Act No. 70/2020 on the resolution of credit institutions and investment firms, the Deposit Guarantees Act was amended so that payments to each depositor shall be the total amount of its covered deposits with the relevant company, but never more than the equivalent of EUR 100,000 in Icelandic Króna.

- Additionally, Rules No.1399/2020, amending the LCR Rules, were brought in. These Rules are intended to ensure that a credit institution always has available assets to meet the foreseeable and potential payment obligations over a given period. The Rules require that credit institutions have available assets to be able to meet not only their maturing obligations, but also possible outflows that may arise, for example, through deposit withdrawals, reduced access to funding or increased collateral requirements or unavoidable lending under stress conditions over the next 30 days. According to Rules No. 1399/2020, the transitions period of Rules No. 1170/2019 amending the LCR Rules will be implemented one year later. The requirements will be introduced in stages, beginning at 30% in 2021, increasing to 40% in 2022 and finally reaching the full 50% at the beginning of 2023.

- Regulation No. 452/2020, amending Regulation No. 233/2017 on prudential requirements for credit institutions and investment firms, came into force in May 2020. The amendments implement Regulation (EU) No. 2017/2395 amends the CRR as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on owned funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any Member State. The amendments aim to reduce the impact on the capital base due to the implementation of IFRS 9 and for the treatment of certain public sector exposures expressed in the home currency of a member state as a large exposure, although the date of 1 February is replaced by 15 June 2020.

- The decision of the EEA Joint Committee No 79/2019 of 29 March 2019 amended Annex IX (Financial services) to the EEA Agreement and incorporated CRR into the agreement. The effect of the incorporation is that from 1 January 2020, the provisions of Article 501 and the CRR, which provides for a discount for exposures of SMEs (SME factor), applies in Iceland.

- Amendments were made to the Competition Act which affect a number of settlements the Bank has concluded with the ICA in relation to exceptions to the prohibition rules of the Competition Act, concerning cooperation between companies. The amendments, which came into force on 1 January 2021, led to certain exemptions granted by the ICA on the basis of an earlier provision, not having the same effect as before. Instead of an arrangement where an exemption was subject to the prior written approval of the ICA, a self-assessment system has been introduced whereby the companies that intend to cooperate will have to assess for themselves whether such co-operation complies with applicable competition rules. The ICA has issued that companies which had been granted an exemption for cooperation will be considered to fulfil the exemption conditions without further consideration until 1 July 2021. As a result of these changes, the Bank will be required to assess for itself whether the conditions for exemptions are met for the cooperation, both at the outset as well as during the term of the cooperation. The burden of proof that the Bank's self-assessment was satisfactory, and the conditions are met, will rest with the Bank. Other settlements concluded between the Bank and the ICA remain unaffected by these amendments to the Competition Act.

These legislative and regulatory changes all present a risk to the Bank in terms of compliance, and the costs on the Bank for doing so may have a negative impact on the Bank's business, prospects, financial position and/or results of operations.

5. The Bank must comply with anti-money laundering and anti-bribery regulations, and the violation of such regulations may have severe consequences

The Bank is subject to laws which aim to combat money laundering, the financing of terrorism and laws that prohibit the Bank (or its employees or intermediaries) from making or offering improper payments to foreign governments, officials and political parties in order to win or keep business. Complying with these laws can be expensive and may require substantial technical capabilities, and require the Bank to, among other things, conduct customer due diligence regarding fiscal evasion, anti-money laundering, sanctions and politically exposed persons screening, keep client and supplier account and transaction information up to date and implement effective financial crime policies and procedures.

The Icelandic government implemented the Fourth Money Laundering Directive in 2018, which came into effect on 1 January and 1 June 2019. Financial crime is continually evolving, and the expectations of regulators are increasing. The regulatory requirements which the Bank is subject to may be changed and cannot be predicted, and the Bank has to be proactive and adaptable in responding to these requirements. The Bank believes that its current policies and procedures are sufficient to comply with applicable anti-money laundering, anti-bribery and sanctions rules and regulations. However, the Bank cannot completely eliminate the risk of money laundering or bribery situations arising, for example by the acts of the Bank's employees, for which the Bank could be held responsible. Any such events can have severe consequences, including sanctions, fines and reputational consequences, which could have a material adverse effect on the Bank's business, prospects, financial position and/or results of operations.

In 2019, Act No. 64/2019 on the freezing of funds and registration of parties on lists of sanctions in connection with the financing of terrorism and distribution of weapons of mass destruction. The main subject of the Act concerns the freezing of funds and the registration of parties on lists in connection with coercive measures. Among other things, the Act stipulates what measures entities which have a notification obligation according to the law on actions against money-laundering and financing of terrorism are required to take to assess whether their customers are on the list of coercive measures. There have been no rules before on the designation and delisting of lists of coercive measures; therefore, to the extent that the Bank is required to change existing policies to comply with these rules, or the impact of further rule changes in the future, this may have an adverse effect on the Bank's business.

In March 2021, the FSA commenced a routine inspection of the risk management of the Bank in respect of anti-money laundering and terrorist financing with focus on cross-border transfer of funds pursuant to Rules No. 70/2019 and the freezing of funds pursuant to Act No. 64/2019. The inspection is still ongoing. Non-compliance may result in administrative fines being imposed.

Following a period in which Iceland was featured on the Financial Action Task Force's ("**FATF**") Grey List, Iceland was announced as having been removed from the Grey List in 2020. This came as a result of enacting further laws, rules and regulations to remove Iceland's status as a Grey List country, caused by previous legislature concerning money laundering and slow-moving monetary reform. While there is nevertheless a risk that any country may be placed on the Grey List, recent systemic changes undertaken within the Icelandic government have demonstrated a national determination to remain unlisted and continue to develop and strengthen its approach to tackling terror funding and money laundering.

6. The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities

The Bank is involved in, or could be affected by, a number of ongoing, pending or threatened proceedings and is subject to investigations by governmental authorities, including, but not limited to:

- *legal proceeding regarding Borgun*: Borgun (currently SaltPay, IIB hf) is a payment acquirer and issuing processer and a former subsidiary of the Bank. Landsbankinn sold its 31.2% stake in Borgun in late 2014. Landsbankinn claims that Borgun's management did not disclose all available information that might have affected the value of Borgun during the sales process, namely the value of its stake in Visa Europe which was sold to Visa International shortly after the Borgun sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit against Borgun and others on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. Landsbankinn does not quantify the claim, but its estimate of the lost profit from having sold its shares in Borgun is approximately ISK 1,930 million. Court appointed assessors presented their assessment in November 2019. A reassessment was demanded, and the senior assessors appointed by the court presented their reassessment in April 2021 which corroborates the previous assessment of Borgun's obligation to disclose. Further, the senior assessors estimated that Borgun's share in the Visa option as of 31 December 2013 amounted to at least ISK 387 million. It is uncertain when a ruling is to be expected. On 11 March 2020, the Bank signed an agreement to sell its 63.47% stake in Borgun to Salt Pay Co Ltd. and concluded the sale on 7 July 2020. In the agreement the Bank undertook to reimburse 63.47% of losses incurred by Borgun or the buyer as a result of an unfavourable outcome in the Landsbankinn case, however such reimbursement was never to exceed the Bank's share in the purchase price (as further outlined below). Since the amount of the claim, the allocation of liability and the possible outcome remain uncertain, the Group has not recognised a provision as a result of this event. For additional information on the sale of Borgun, see "*Legal Considerations and Supplementary Information—Acquisitions and Disposals*"; and

- *threatened lawsuits of the Consumer Association:* on 19 May 2021 the Icelandic Consumer Association announced on its website and the major news media that the association intends to initiate a lawsuits against the Icelandic commercial banks and other loan institutions. The purpose of the lawsuits is to challenge the legitimacy of how floating interest rates on loans to consumers are adjusted. The association considers the basis on which adjustments of such floating interest rates are made to be in violation of the loan agreements' provisions and not sufficiently transparent and will claim both an annulment of the relevant provision of the loan agreement and a repayment of overpaid interest. The association intends to file at least three cases before the district courts and is encouraging borrowers to participate in the lawsuits. As of the date hereof, hundreds of borrowers have already showed interest in participating in the lawsuits according to information published by the association. No lawsuits against the Bank have been filed as of the date of this Prospectus and it is still uncertain whether and when such lawsuits will be filed. The Bank has not estimated the possible exposure of such claims being acknowledged by the courts, but it is apparent that it could have a significant adverse effect on the Bank. As at 31 March 2021, 21% of loans to customers were loans to individuals with floating interest rates.

The Bank's subsidiaries are involved in, or could be affected by, a number of ongoing proceedings and are subject to investigations by governmental authorities, including, but not limited to:

- *dispute regarding 105 Miðborg Project*: The professional investor fund 105 Miðborg slhf., operated by Iceland Funds, a wholly owned subsidiary of the Bank, recently terminated its contractor agreement with ÍAV hf., the contractor retained for a real estate project at Kirkjusandur in the centre of Reykjavík. The main reason for the termination related to significant non-performance and delays in the construction of one building on the premises. The contractor, ÍAV hf., has claimed approximately ISK 3,829 million plus late payment interest and legal costs from the fund and Iceland Funds to compensate for the alleged unlawful termination. The case was filed on 11 May 2021 at the District Court of Reykjavík. In a written brief of dismissal, Iceland Funds opposed their involvement in the case on the basis that the contractual relationship was between ÍAV hf. and 105 Miðborg slhf. Further, the fund has issued a subpoena against ÍAV hf. claiming approximately ISK 3,878 million plus late payment interest and legal cost due to delay and significant breaches of contract. The Bank owns a 6.25% stake in the fund. The Group has not recognised a provision in respect of this matter.

Other contingent liabilities relating to the Bank, or that could materially affect the Bank, include:

- *liabilities relating to the sale of Borgun*: as discussed above the Bank entered into a share purchase agreement in March 2020 pursuant to which the Bank sold all its stake in Borgun to Salt Pay Ltd. As customary in M&A transactions, the Bank is liable for breach of warranty given to the buyer pursuant to the share purchase agreement. Further the Bank undertook to indemnify the buyer against losses arising out of or in connection with the Landsbankinn case (referred to above) and specific unsettled claims and chargeback risk of certain customers of Borgun. In all instances the Bank's liability is capped to 63.47% of the losses and may never exceed the Bank's share in the purchase price (approximately EUR 17.2 million). For the reasons noted above, the Bank is not able to quantify its expected exposure at this time.

For additional information on legal proceedings, see "*Business Overview—Legal Proceedings*".

The Bank is at risk of claims being brought by various parties. Firstly, the Bank is a commercial bank and as such grants number of loans to consumers. Thereby the Bank is subject to the consumer legislation that imposes various obligations on the Bank, such as extensive information obligation. There is a risk that consumers bring a claim against the Bank for failing to properly inform them of risk and cost deriving from their borrowing, such as relating to interest or indexation. Secondly, given the Bank is a financial services firm and consultant to customers in respect of its Investment Banking division, the Bank could incur liability through its role in determining the price of companies, advising parties in corporate transactions and in disputes over the terms and conditions of trading arrangements. There is also the risk that counterparties could bring a claim against the Bank for failing to properly inform them of associated risks. Thirdly, the Bank could be subject to claims from current and former employees in relation to any alleged illegal dismissal, discrimination or harassment. In contrast, the Bank could experience financial loss or reputational damage as a result of illegal actions by employees or third-party service providers in the workplace. These risks can be unexposed for some time and it can be challenging to quantify the risk and scale of the issue. If any legal proceedings or investigations are determined adversely to the Bank, the Bank could be required to pay damages and/or fines and be subject to future restrictions on its business activities. This could adversely impact the Bank's financial position.

7. The Bank could incur unforeseen liabilities from prior and future acquisitions and disposals

The Bank may decide to make business acquisitions or dispose of part of its current business in the future and doing so would expose various risks to the Bank. In relation to acquisitions, the Bank may encounter challenges when trying to integrate the new business, and the combined business may not be as successful as planned. This in turn could cause key employees to leave the Bank if they are not satisfied with the changes to operations, which could have a negative impact on the Bank business, prospects, financial position and/or results of operations.

Acquisitions could also expose the Bank to unforeseen expenses, losses and tax liabilities, as well as obligations to employees, customers and business partners. The Bank will assess the potential value of the target before making the acquisition. However, the Bank cannot be certain that its due diligence assessment will be sufficient or will reveal all of the risks associated with the target or the full extent of any risks. This is because the Bank will have to rely on the resources available to it and possibly research carried out by third parties. In addition, it is possible for liabilities to arise which were not apparent at the time the target company was acquired. In order to mitigate these risks, the Bank will obtain warranties and indemnities from the seller. However, there is a risk that the warranties and indemnities might not cover all of the liabilities that arise following the acquisition, and the amounts agreed under the indemnities might not fully compensate the Bank for any diminution in the value of its interest in the business. The Bank could have difficulties enforcing warranties or indemnities against a seller for various reasons, for example, if the seller becomes insolvent or the limitation periods have expired.

On a disposal of a part of the business or asset, the Bank may not be able to pass on all of the risks relating to the business or assets being sold to the buyer meaning the Bank can still be liable. Additionally, the Bank could also face damage to reputation and negative public opinion upon a disposal if, for example, the business or asset is sold at a perceived discount.

For further information regarding unforeseen liabilities relating to prior disposals, see "*—The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities* ".

8. The Bank has a high proportion of inflation-linked mortgage loans and there is a risk that legislation might be imposed which varies the terms of those loans in a manner that is adverse to the Bank

A high proportion of the Bank's mortgage loans are inflation-linked. Under these loans, the monthly repayment increases if and to the extent that inflation in Iceland increases. Following the financial crisis in 2008, inflation in Iceland increased significantly. This resulted in higher payments falling due under inflation-linked loans at the same time as borrowers faced lower wages and less purchasing power. There was significant debate in Iceland regarding these loans in the period preceding the parliamentary elections in April 2013. The Icelandic government announced at the end of November 2013 an action plan aimed at reducing the country's housing debt. On the basis of the action plan, the Icelandic Parliament passed Act No. 35/2014 and Act No. 40/2014. The objective of Act No. 35/2014 was to write down the principal of indexed residential mortgages and was financed by an increase in the Bank Levy (see "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Regulatory Developments—Bank Levy*"), which has increased the Bank's financial burden and decreased its profitability. Act No. 40/2014, which amended the Pension Act No. 129/1997, authorised households with residential mortgages, in the period between 1 July 2014 and 30 June 2017, to use payments which would otherwise go to a private pension fund to reduce the principal amount of their mortgages. This option has since been extended until 30 June 2021, and a draft bill has been submitted to the Parliament whereunder it is suggested the option is further extended until 30 June 2023. This option is open to all residential mortgage holders, regardless of the form of their mortgage. There is a risk that additional legislation may be adopted or other government action taken to reduce the payment burden under inflation-linked mortgages. Should this occur, it would have a materially negative impact on the Bank's loan portfolio, financial condition and results of operations.

9. COVID-19 has created legal and regulatory compliance obligations for the Bank

The Icelandic government has implemented many measures to support companies in relation to the pandemic, such as by supporting salary payments to employees, granting tax relief and financial support to those that were required to temporarily cease operation. The legislation that has primarily affected the Bank's operations are Act No. 38/2020 on support loans and financial support to smaller companies, pursuant to which the Bank can grant loans to companies meeting certain criteria supported by 85-100% state guarantees, and Act No. 57/2020 on temporary authorisation from financial restructuring, which provides for more extensive moratoria than provided in the bankruptcy legislation.

The Bank was also a party to a moratorium agreement between the Icelandic commercial banks, pension funds and other lenders signed in March 2020 under which certain companies that met certain criteria were granted a six-month grace period from all repayments, including interest and instalments (however in no case longer than until year-end 2020). The agreement was extended in July 2020 but expired in the beginning of 2021. Since the moratorium agreement lapsed the Bank has deferred payments on case-by-case basis.

In addition, payment obligation has been challenged before Icelandic courts due to the COVID-19 pandemic. With a recent judgement of a District Court, it was considered unfair for a lessee (being a hotel) to pay a full rent during the pandemic. On 4 May 2021, the Supreme Court of Iceland granted the lessor a right to appeal directly to the Supreme Court, bypassing the Court of Appeals. The right of appeal was granted as the case was considered to have importance on numerous agreements that have been affected by the COVID-19 pandemic and therefore it was urgent to receive a decision from the Supreme Court as quickly as possible. The judgment has not been rendered. If confirmed by the Supreme Court, such a finding could impose a risk on the Bank should the lessors (being the borrowers) that are affected by such judgement, seek similar relief from their commercial bank.

10. Iceland's national implementation of the EEA rules may not be comprehensive in all circumstances

As a member state of the EEA, Iceland is obligated to implement parts of European Union law. A large amount of Icelandic legislation relating to the financial services industry, such as the legislation on financial undertakings, securities transactions and other legislation relating to financial markets, is implemented from EU law. If the state fails to draft national law in a way that conforms with EEA rules, Icelandic citizens may not be able to rely on national laws, and the Icelandic courts could be restricted from applying them unless the Icelandic legislation can be interpreted in a way which conforms with EU legislation. There can be errors in the implementation of EU law and in those cases, Icelandic law will be deemed to prevail in the Icelandic courts. Inconsistencies between EU law and Icelandic law can lead to uncertainty over which rules the Bank must follow, which can take up a lot of the Bank's resource and time in trying to identify which rules to follow.

There can be a delay before Icelandic law EU legislation, which could also feed into the Bank's uncertainty as to which rules it must comply with. Icelandic authorities may try to reduce uncertainty by working off requirements under the new EEA rules, which are in the process of being implemented. As a result, the Bank may be unable to rely on the precise wording of current statutes or draw guidance from legislative preparatory works. Working to comply with regulations which are changing can be resource intensive and exposes the Bank to a risk of non-compliance.

11. Improving technological developments may lead to new and more detailed reporting and monitoring obligations of the financial industry. This could force the Bank to make significant investments and increase its compliance burden with a material adverse effect on the Bank's business, results of operations and financial condition

New technological developments lead, at least in theory, to increased knowledge within the financial industry about clients and their behaviour. Governmental authorities could decide to increasingly use the industry for achieving certain policy goals and for the enforcement of rules that strictly speaking do not regard the financial industry. To date, governments have invoked the assistance of the financial industry for purposes such as combating terrorism, preventing tax evasion and detecting signals of possible money laundering. In the future, as technological possibilities improve, governments and supervisory authorities could expect the industry to detect other unusual or illegal behaviours by clients, even though the systems being used in the industry may not have been designed to make such assessments.

If new, different or more detailed reporting or monitoring obligations of this nature were to be imposed on the Bank, then this could force it to make significant additional investments in technology or processes. For example, if the Bank were to be able to monitor transactions in new ways, more unusual transactions might possibly be detected as these are defined under current rules, which might then require the Bank to follow up on a greater number of signals of inappropriate transactions, which in turn requires more resources.

If as a result of improving technological means, governments and supervisory and other authorities impose new and more detailed reporting and monitoring obligations on the Bank, this could force it to make significant investments and increase its compliance burden with a material adverse effect on the Bank's business, reputation, results of operations and financial condition.

12. The Capital Controls restrict to some extent the manner in which the Bank conducts its business

In response to the financial crisis, the Parliament of Iceland approved certain amendments to Act No. 87/1992 on Foreign Exchange, as amended (the "**Foreign Exchange Act**") that introduced the Capital Controls in 2008. The Capital Controls effectively prohibited the cross-border transfer of funds, except in certain circumstances, such as the payment for goods or services and transfers permitted under applicable statutory exemptions. Therefore (unless expressly permitted) financial transactions resulting in cross-border currency transactions and including lending and borrowing between resident and non-resident parties, as well as currency derivatives of any kind and the acquisition by domestic parties of financial instruments denominated in foreign currency, were prohibited. As a result, the Capital Controls made it compulsory for Icelandic nationals and companies to repatriate all foreign currency not subject to those statutory exemptions. With the Capital Controls being largely lifted in 2017 the Foreign Exchange Act currently contain statutory general exemptions to the Capital Controls, and also allow the Bank to seek approval from the Central Bank of Iceland for a specific exemption.

As an Icelandic resident entity the Group is subject to the Capital Controls but benefits from both the general and specific exemptions. If the exemptions did not apply, the Capital Controls could have a different impact on the Group's operations depending on the type of cross-border activity engaged in by the Group. Currently, financial institutions, including the Group, enjoy a specific statutory exemption from the Capital Controls allowing unrestricted domestic interbank market trade in currencies when settled on a trade, using futures and swaps. Financial institutions, including the Bank, are also exempt from restrictions on cross-border borrowing and lending, the provisions of cross-border guarantees and obligations to remit foreign currency to Iceland. Finally, the exemption allows financial institutions, including the Group, to accept money market deposits denominated in Icelandic Króna from non-resident entities. However, although specific terms of transactions may fall within exemptions, the overall transactions may nevertheless be restricted by the Capital Controls if it were not for the general exemption. Moreover, in an insolvency situation, the Bank may not benefit from the exceptions from the Capital Controls, and, therefore, the Bank may be restricted in respect of making payments in foreign currencies and transferring funds cross-border, whether under the Foreign Exchange Act, the Act on Bankruptcy No. 21/1991, as amended, or applicable provisions under the Financial Undertakings Act.

Since 2015 the government has largely removed the Capital Controls and in February 2021, the Minister of Finance and Economic Affairs (the "**Minister**") submitted a draft bill to the Parliament for a new Foreign Exchange Act, which is expected to be accepted and entered into force mid- or second half of 2021, subject to Parliamentary processes and acceptance. The draft bill is based on the principle that foreign exchange transactions, cross-border payments and the flow of capital between countries are free and unrestricted, but with the proviso that certain protective measures can be applied, for example, in the form of macroeconomic prudential instruments or measures comparable to the Capital Controls that were established in the wake of the bank collapse in 2008. See "*Regulatory Overview—Principal Legislation and Regulations—Foreign Exchange Act*".

13. The Group's business operations require precise documentation, recordkeeping and archiving. Any failure to do so could cause the Group to violate regulatory requirements, could prevent it from adequately monitoring transactions and claims or litigation, and could preclude it from enforcing agreements in accordance with their intended terms, all with a potential material adverse effect on the Group's business, reputation, results of operations and financial condition

The Group's business operations require precise documentation, recordkeeping and archiving. Incomplete documentation, documentation not properly executed by counterparties, inadequate recordkeeping or archiving, including the ability to promptly reproduce the information stored in a demonstrable authentic, unchanged, unmodified or unaltered fashion, and the loss of documentation—both physical and electronic documentation—could materially and adversely affect the Group's business operations in a number of ways. Technical limitations, end of lifecycles, erroneous operational decisions, inadequate policies, human mistakes, outdated computer systems and programmes for the storage of older data, system failures, system decommissioning, underperforming third party service providers and inadequate and incomplete arrangements with third party service providers (including where the business continuity and data security of such third parties proves to be inadequate), may all lead to incomplete or inappropriate documentation or data, the loss or inaccessibility of documentation or data, and non-compliance with regulatory requirements.

The risk is further exacerbated by the increased use of technology and modern media for interacting with customers and entering into transactions with or selling products and services to them. For example, documentation and recordkeeping when clients use the internet or hand-held devices for entering into transactions with the Bank are in certain respects more complex (with electronic signatures having to be verified and pages visited and general terms accepted having to be stored) than with more traditional paper-based methods for entering into transactions. Furthermore, if client or transaction files are not complete, this could preclude the Bank from enforcing or performing agreements in accordance with their intended terms. Accordingly, if the Bank should fail in respect of proper documentation, recordkeeping and archiving, or in obtaining the right and complete information, this could not only lead to fines or other regulatory action, but also materially and adversely affect its business, reputation, results of operations and financial condition.

Risks Relating to the Offering and the Offer Shares

1. The market price of the Offer Shares may fluctuate and could fall below the Offer Price

The Bank cannot guarantee that the Offer Shares that will be issued as a result of the Offering will trade at a price equal to or higher than the Offer Price. There has been no prior public market for the Shares prior to the Offering, and as such there is no certainty that an active trading market for the Shares will develop. Even if an active trading market does develop, there is no guarantee that it will continue after the Offering. The Offer Price may not be indicative of the market price for the Shares following their listing on Nasdaq Iceland. The liquidity and trading price of the Shares may be highly volatile in response to factors including (but not limited to) adverse judicial or extrajudicial decisions, the Bank's real or perceived financial performance, large purchases or sales of the Shares, negative publicity, changes to legislation or regulations, macroeconomic conditions and the financial markets. Regardless of the Bank's performance and market conditions, fluctuations may occur and could have a negative impact on the market price of the Shares resulting in losses to investors. The Offer Price, which may bear no relationship to the price at which the Shares will trade upon the completion of the Offering, will be agreed between the Selling Shareholder and the Ministry of Finance and Economic Affairs (the "**Ministry of Finance**"), based on close consultation with the Joint Global Coordinators.

2. Substantial future sales of Shares could adversely affect the market price of the Shares

The issuance or sale of a substantial number of the Bank's shares during or after the Offering, or the perception that an issuance or sale may occur, could adversely affect the trading price of the Shares and their market value, as well as limit the Bank's ability to raise capital and obtain additional funding through a future share issuance. Upon completion of the Offering, the Selling Shareholder will hold approximately 71.5% of the Shares, assuming that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised (68.7% if the Over-Allotment

Option is exercised in full). The Bank cannot predict any effect that future sales of the Shares, or the availability of the Shares for future sale, will have on the market price of the Shares. The market price of the Shares could be adversely affected by the perceived or actual sales of substantial amounts of the Shares by the Selling Shareholder, or an announcement that sales of Shares could take place, following the expiration of the applicable lock-up period or pursuant to the applicable carve-outs to the lock-up arrangements, as described in "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

During the periods immediately before and following the end of the periods of sales restriction provided for by these lock-up arrangements, the market price of the Shares may fall in anticipation of a sale of the Shares. Following the expiry of these arrangements, there will be no contractual restriction on the sale of the Shares owned by the Selling Shareholder who was previously subject to them. The Bank is not able to predict whether a substantial number of the Shares in addition to the Offer Shares will be sold in the open market following the expiry (or waiver) of these restrictions. In particular, the Bank cannot give any assurances that, after the restrictions expire or before any restrictions are waived, the Selling Shareholder will not reduce its holdings of the Shares.

3. Depending on its level of shareholding, the Icelandic state may be able to exercise influence on the Bank, and its interests may conflict with those of the Bank's other shareholders

The Selling Shareholder manages the Shares on behalf of the Icelandic state on an arms-length basis in accordance with Act No. 88/2009 and Act No. 155/2012. If the Icelandic state continues to retain a significant proportion of the Shares following the Offering and, consequently, an interest in the Bank, the Icelandic state and the government in power could have an influence on the Bank's management and affairs and on the outcome of most matters submitted to its shareholders for approval. If the Icelandic state and the government in power remained a significant shareholder following the Offering and in accordance with Icelandic law, such matters could include the election of the Board of Directors, the issuance of additional Shares and other equity securities, which may dilute existing holders of the Shares, and the payment of any dividends. The interests of the Icelandic state may differ from or compete with those of the Bank's other shareholders.

Accordingly, this concentration of ownership could have a material adverse effect on the market price of the Offer Shares by, among other things, delaying, deferring or preventing a change in control, impeding a merger or discouraging a potential acquirer from making a tender offer or otherwise attempting to obtain control of the Bank.

4. The Bank's ability to declare a dividend in the future is subject to a variety of factors

The Bank's shareholders will determine whether future dividends will be declared and paid following a proposal from the Board of Directors and will depend on various factors, including the evolution of the business, its financial condition, operating results, prospects/opportunities, capital requirements, the ability of its subsidiaries to pay dividends to the Bank, credit terms and any statutory restrictions or recommendations from the authorities. General public opinion can also impact the payment of dividends, and in the past, some companies have gone as far as to change their plans for paying dividends in light of negative opinion of the public. The Bank would also need to consider the potential for any dividend payment to create a large exposure for the Bank, defined as exposure to a single borrower or a group of financially related borrowers which exceeds 10% of the Bank's eligible capital.

Additionally, the Central Bank of Iceland imposes strict guidelines on the Bank regarding currency imbalance, liquidity and capital position. When considering if to declare and pay a dividend, the Bank must ensure that it holds sufficient funding sources in Icelandic Króna in order to make the payment and to still meet capital and liquidity requirements.

The Bank cannot guarantee that dividends will be payable or paid in the future, or that, if they are paid, that they will increase over time. See "*Shares and Share Capital—Dividends and Dividend Policy*".

5. Future offerings of debt or equity securities by the Bank may adversely affect the market price of the Shares

The Bank could in the future want to increase its capital resources by offering Shares, preference shares, or debt securities such as commercial paper, medium-term notes, senior or subordinated notes. If the Bank then later becomes insolvent, entities or individuals who hold preference shares or debt securities and other creditors would receive a distribution of the Bank's available assets before the holders of the Shares. Additionally, further equity offerings may dilute the voting rights of the Bank's existing shareholders and could potentially reduce the market price of the Shares. Additionally, the holders of Shares may be less likely to receive a dividend if preference shares have been issue.

6. Risk of Share Dilution

Issuing new shares can cause the value of existing shareholders' shares to reduce, and therefore dilute their proportion of ownership. Current Articles of Association, dated 26 May 2021, do not contain any capital increase authorisations but shareholders meeting can decide to increase the Bank's capital or grant the Board of Directors with such authorisation by amending the Articles of Association on a shareholder meeting. Amendments to the Articles of Association require approval of 2/3 majority of votes cast and shareholders controlling at least 2/3 of the share capital represented at the meeting.

7. Risk relating to transferability of the Shares

The Shares are not subject to any restrictions on transferability on Nasdaq Iceland, and the Bank's Articles of Association, dated 26 May 2021, do not contain any restrictions on shareholders' rights to dispose of their shares in the Bank. However, the Articles state that qualifying holdings are subject to limitations under the Financial Undertakings Act, which contains rules on qualifying holdings in financial institutions. These state that if an investor wishes to acquire a qualifying holding of 10% or more in a financial undertaking such as the Bank, whether alone or with others, the party must notify the FSA in advance of its plans. Similarly, notification must be given to the FSA if an investor, whether alone or in concert with others, increases its shareholding so that it exceeds 20%, 25%, 33% or 50%, or becomes so large that the Bank is considered to be its subsidiary. Alternatively, if the owner of a qualifying holding wishes to reduce its shareholding so that it no longer owns a qualifying holding, the owner shall notify the FSA in advance, setting out what its resulting holding will be. If the holding is below 20%, 25%, 33% or 50%, or to such an extent that the financial undertaking ceases to be a subsidiary of the undertaking concerned, this must also be notified. The same notification requirements apply if a proportional holding decreases as a result of an increase in share capital or guarantee capital.

The registration of lien rights and changes in ownership how they are implemented is subject to the applicable legislation on electronic registration of title to securities, as provided for in the Articles of Association.

8. Preferential rights for U.S. and other non-Icelandic holders of the Shares may not be available

Existing holders of the Shares are usually entitled to preferential rights to subscribe for new Shares if the company increases its share capital unless shareholders waive such rights by passing a resolution at a general meeting of the shareholders. Holders of the Shares located in the United States cannot exercise any preferential right unless these rights and the Shares are registered under the U.S. Securities Act or an exemption from the registration requirements applies. The Bank is unlikely to file a registration statement and it cannot guarantee to prospective investors that an exemption from the registration requirements would be available to enable U.S. or other non-Icelandic holders of the Shares to exercise any preferential rights or, even if an exemption was available, that the Bank would make use of an exemption.

9. Enforceability in Iceland of claims based on the United States federal securities laws

The Bank is a public limited company established under Icelandic law. The majority of the members of the Board of Directors, the Executive Committee and the Selling Shareholder reside outside the United States and a large proportion of the Bank's assets (and the assets of the members of the Board of Directors, the Executive Committee and the Selling Shareholder) are located outside the United States. Investors may not be able to effect service of process within the United States upon the Bank (or members of the Board of Directors, the Executive Committee or the Selling Shareholder) or to enforce in the United States courts any judgements against them obtained in those courts based upon the civil liability provisions of the United States federal securities laws. There is considerable doubt as to the enforceability in Iceland of claims based on the United States federal securities laws, whether by original actions or by seeking to enforce a judgement of a U.S. court.

10. The Bank may be classified as a Passive Foreign Investment Company ("PFIC")

The Bank does not expect to be classified as a PFIC for U.S. federal income tax purposes for its taxable year ended on 31 December 2020, the current taxable year or in the foreseeable future taxable years, although there can be no assurances in this regard. The Bank's status as a PFIC in any year depends on its assets and activities in that year. Additionally, the determination is based in part on proposed regulations upon which taxpayers may rely, but which may be subject to change as and when adopted as final regulations. PFIC status is inherently factual in nature, may depend in part on fluctuations in the market price of the Bank's shares, is determined annually, and generally cannot be determined until the close of the taxable year. As a result, there can be no assurance that the Bank will not be considered a PFIC for any taxable year. Moreover, if the Bank is or becomes classified as a PFIC, it could have materially adverse consequences for U.S. investors in the Offer Shares. See *"Taxation –U.S. Federal Income Tax Considerations – Passive Foreign Investment Company Rules"*.

11. Exchange rate fluctuations could have an adverse impact on the value of a non-Icelandic holder's Offer Shares and dividends

The share capital of the Bank is denominated and traded in Icelandic Króna. An investment in the Offer Shares by an investor whose principal currency is not Icelandic Króna exposes the investor to foreign currency exchange rate risk. Any depreciation of Icelandic Króna in relation to such foreign currency will reduce the value of the investment in the Offer Shares or any dividends in foreign currency terms.

Dividends are declared at the Annual General Meeting and paid in Icelandic Króna. The date for the payment of dividends in Iceland is decided by the shareholders at a general meeting (whether an Annual General Meeting or an extraordinary general meeting).

12. The ability of shareholders to remit any proceeds denominated in Icelandic Króna from a sale of the Shares is subject to compliance and notification requirements under the Capital Controls

The Capital Controls, as currently implemented, allow investors who are not residents of Iceland to invest in the Shares and to forward the proceeds in Icelandic Króna outside of Iceland. Pursuant to Rules No. 200/2017 on Foreign Exchange, non-resident investors must notify the Central Bank of Iceland if they buy Shares in Icelandic Króna, and if they go on to sell their Shares in Icelandic Króna.

13. Recovery and resolution regimes may affect the rights and remedies of holders of the Offer Shares

The BRRD, which came into force on 2 July 2014, permits competent authorities to intervene quickly should a bank be in difficulty, to ensure the continuity of the bank's critical financial and economic functions, and minimising the wider impact on the economy. The BRRD provides that it will be applied by the member states of the EEA have been obliged to apply it since 1 January 2015 (with the exception of the general bail-in resolution tool, which the member states of the EEA have been obliged to apply since 1 January 2016). The BRRD impacts how credit institutions and investment firms are managed and can also impact the rights of creditors. Measures taken to save the Bank could include strengthening of the Bank's capital by issuing Shares in a situation of financial distress and/or write down or conversion into equity of the Bank's indebtedness, either of which could result in dilution of the purchasers of the Offer Shares. The exercise of any power under the BRRD, or any suggestion of such exercise, could materially adversely affect the price or value of the Offer Shares.

IMPORTANT INFORMATION

This Prospectus has been approved by the FSA as competent authority under Regulation (EU) 2017/1129. The FSA only approves this Prospectus as meeting the standard of completeness, comprehensibility and consistency imposed by the Prospectus Regulation. Such approval of the FSA shall not be considered as an endorsement to the Bank or the quality of the Offer Shares. Investors shall make their own assessment as to the suitability of investing in the Offer Shares. This Prospectus is available at the FSA website (www.fme.is) and the Bank's website (www.islandsbanki.is) and will remain publicly available on the Bank's website for at least 10 years following the date hereof.

The distribution of this Prospectus and the offer, acceptance, delivery, transfer, exercise, purchase of or trade in the Offer Shares may, in certain jurisdictions, including, but not limited to, the United States, be restricted by law. Persons in possession of this Prospectus are required to inform themselves about, and to observe, such restrictions. Any failure to comply with such restrictions may constitute a violation of the securities laws of any such jurisdiction. This Prospectus may not be used for, or in connection with and does not constitute an offer to sell or an invitation to purchase, any of the Offer Shares in any jurisdiction in which such offer or invitation is not authorised or would be unlawful. Neither this Prospectus nor any related materials may be distributed or transmitted to, or published in, any jurisdiction except under circumstances that will result in compliance with any applicable laws or regulations.

None of the Bank, the members of the board of directors of the Bank (the "**Board of Directors**"), the executive committee of the Bank (the "**Executive Committee**"), the Selling Shareholder, the Managers or any of their respective representatives is making any representation to any offeree or purchaser of the Offer Shares regarding the legality of an investment in the Offer Shares by such offeree or purchaser under the laws applicable to such offeree or purchaser.

All purchasers of the Offer Shares are deemed to acknowledge that (i) they have not relied on the Managers or any person affiliated with them in connection with any investigation of the accuracy of any information contained in this Prospectus or their investment decision and (ii) they have relied only on the information contained in this Prospectus, and that no person has been authorised to give any information or to make any representation concerning the Bank, the Selling Shareholder or the Offer Shares (other than as contained in this Prospectus) and that, if given or made, any such other information or representation has not been relied upon as having been authorised by the Bank, the Selling Shareholder or any of the Managers.

EXCEPT AS OTHERWISE SET FORTH IN THIS PROSPECTUS, THE OFFERING DESCRIBED IN THIS PROSPECTUS IS NOT BEING MADE TO INVESTORS IN THE UNITED STATES, CANADA, AUSTRALIA OR JAPAN.

This Prospectus does not constitute or form part of any offer or invitation to sell, or any solicitation of any offer to acquire, the Offer Shares in any jurisdiction in which such an offer or solicitation is unlawful or would result in the Bank becoming subject to public company reporting obligations outside Iceland.

The distribution of this Prospectus, and the offer or sale of the Offer Shares, is restricted by law in certain jurisdictions. This Prospectus may only be used where it is legal to offer, solicit offers to purchase or sell the Offer Shares. Persons who obtain this Prospectus must inform themselves about and observe all such restrictions.

No action has been, or will be, taken to permit a public offer or sale of the Offer Shares or the possession or distribution of this Prospectus or any other material in relation to the Offering in any jurisdiction outside Iceland where action may be required for such purpose. Accordingly, neither this Prospectus nor any advertisement or any other related material may be distributed or published in any jurisdiction, except in compliance with any applicable laws and regulations. See "*Plan of Distribution and Transfer Restrictions—Selling and Transfer Restrictions*".

United States

The Offer Shares have not been, and will not be, registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and may not be offered or sold within the United States, unless the Offer Shares are registered under the U.S. Securities Act or pursuant to an exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act. In the United States, the Offer

Shares will be sold only to persons reasonably believed to be QIBs as defined in, and in reliance on, Rule 144A under the U.S. Securities Act or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act and applicable state securities laws. All offers and sales of the Offer Shares outside the United States will be made in compliance with Regulation S under the U.S. Securities Act and in accordance with applicable law. See "*Plan of Distribution and Transfer Restrictions—Selling and Transfer Restrictions*". The Offer Shares have not been recommended by any U.S. federal or state securities commission or regulatory authority. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this Prospectus. Any representation to the contrary is a criminal offence in the United States.

European Economic Area

This Prospectus and the Offering are only addressed to, and directed at, persons in member states of the European Economic Area (the "**EEA**") who are "**Qualified Investors**" within the meaning of Article 2 (e) of the Prospectus Regulation. Save for in Iceland, the Offer Shares are only available to, and any invitation, offer or agreement to purchase or otherwise acquire the Offer Shares will be engaged in only with, Qualified Investors. This Prospectus and its contents should not be acted or relied upon in any member state of the EEA by persons who are not Qualified Investors.

This Prospectus has been prepared on the basis that all offers of the Offer Shares, other than the offers contemplated in Iceland, respectively, will be made pursuant to an exemption under the Prospectus Regulation, as implemented in member states of the EEA, from the requirement to produce a prospectus for offers of the Offer Shares. Accordingly, any person making or intending to make any offer within the EEA of the Offer Shares that is the subject of the Offering contemplated in this Prospectus should only do so in circumstances in which no obligation arises for the Bank, the Selling Shareholder or any of the Managers to produce a prospectus for such offer. None of the Bank, the Selling Shareholder or the Managers has authorised, nor does the Bank, any of the Selling Shareholder or the Managers authorise, the making of any offer of the Offer Shares through any financial intermediary, other than offers made by the Managers that constitute the final Offering of the Offer Shares contemplated in this Prospectus.

For the purposes of this provision, (a) the expression an "**offer to the public**" in relation to any Offer Shares in any member state of the EEA that has implemented the Prospectus Regulation (including Iceland) (each, a "**Relevant Member State**") means the communication in any form and by any means of sufficient information on the terms of the Offering and the Offer Shares so as to enable an investor to decide to purchase the Offer Shares, as the same may be varied in such Relevant Member State by any measure implementing the Prospectus Regulation in such Relevant Member State, (b) the expression "**Prospectus Regulation**" means Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017, and (c) the expressions "**Relevant Member State**", "**member states of the EEA**", "**any member state of the EEA**" and "**within the EEA**" do not include Iceland.

United Kingdom

This Prospectus and the Offering is addressed only to persons who (i) have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (the "**FSMA**") (Financial Promotion) Order 2005, as amended (the "**Financial Promotion Order**"), (ii) are persons falling within Article 49(2)(a) to (d) ("high net worth companies, unincorporated associations etc.") of the Financial Promotion Order, (iii) are outside the United Kingdom, or (iv) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the FSMA) in connection with the issue or sale of any securities may otherwise lawfully be communicated or caused to be communicated (all such persons together being referred to as "relevant persons"). This Prospectus is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this Prospectus relates is available only to relevant persons and will be engaged in only with relevant persons. This Prospectus has been prepared on the basis that any offer of the Offer Shares referred to herein in the UK will be made pursuant to an exemption under the Prospectus Regulation as it forms part of domestic law by virtue of the EUWA (the "**UK Prospectus Regulation**") from the requirement to publish a prospectus for offers of the securities referred to herein. Accordingly, any person making or intending to make an offer in the UK of Offer Shares which are the subject of the Offering only do so in circumstances in which no obligation arises for the Bank, the Selling Shareholder or any of the Managers to publish a prospectus pursuant to Article 3 of the UK Prospectus Regulation, in each case, in relation to such offer. Neither the Bank nor the Selling Shareholder nor any of the Managers have authorised, nor do they authorise, the making of any offer of Offer Shares in circumstances in which an obligation arises for the Bank, the Selling Shareholder or any of the Managers to publish a prospectus for such offer.

The Offer Shares described in the Prospectus are not intended to be offered, sold, distributed or otherwise made available to and should not be offered, sold, distributed or otherwise made available to any retail investor in the UK. For these purposes, a retail investor means a person who is one (or more) of: (i) a retail client, as defined in point (8) of Article 2 of Regulation (EU) No 2017/565 as it forms part of domestic law by virtue of the European Union (Withdrawal) Act 2018 ("EUWA"); or (ii) a customer within the meaning of the provisions of the FSMA and any rules or regulations made under the FSMA to implement the Insurance Distribution Directive, where that customer would not qualify as a professional client, as defined in point (8) of Article 2(1) of Regulation (EU) No 600/2014 as it forms part of domestic law by virtue of the EUWA. Consequently no key information document required by the PRIIPs Regulation as it forms part of domestic law by virtue of the EUWA (the "**UK PRIIPs Regulation**") for offering, selling or distributing the Offer Shares or otherwise making them available to retail investors in the UK has been prepared and therefore offering, selling or distributing the Offer Shares or otherwise making them available to any retail investor in the UK may be unlawful under the UK PRIIPs Regulation.

Notice to Certain Overseas Persons

The Offer Shares will not qualify for distribution under the relevant securities laws of Australia, Canada, the Republic of South Africa or Switzerland, nor has any prospectus in relation to the Offer Shares been lodged with, or registered by, the Australian Securities and Investments Commission or any regulatory authority in Australia, Canada, the Republic of South Africa or Switzerland. Accordingly, subject to certain exemptions, the Offer Shares may not be offered, sold, taken up, delivered or transferred in, into or from Australia, Canada, the Republic of South Africa, Switzerland or any other jurisdiction where to do so would constitute a breach of local securities laws or regulations (each a "**Restricted Jurisdiction**") or to or for the account or benefit of any national, resident or citizen of a Restricted Jurisdiction. This document does not constitute an offer to issue or sell, or the solicitation of an offer to subscribe for or purchase, any Offer Shares to any person in a Restricted Jurisdiction and is not for distribution in, into or from a Restricted Jurisdiction.

Information to Distributors

Solely for the purposes of the product governance requirements contained within: (a) EU Directive 2014/65/EU on markets in financial instruments, as amended ("**MiFID 2**"); (b) Articles 9 and 10 of Commission Delegated Directive (EU) 2017/593 supplementing MiFID 2; and (c) local implementing measures (together, the "**MiFID 2 Product Governance Requirements**"), and disclaiming all and any liability, whether arising in tort, contract or otherwise, which any "manufacturer" (for the purposes of the Product Governance Requirements) may otherwise have with respect thereto, the Shares have been subject to a product approval process, which has determined that such Shares are: (i) compatible with an end target market of retail investors and investors who meet the criteria of professional clients and eligible counterparties, each as defined in MiFID 2; and (ii) eligible for distribution through all distribution channels as are permitted by MiFID 2 (the "**Target Market Assessment**"). Notwithstanding the Target Market Assessment, distributors should note that: the price of the Shares may decline and investors could lose all or part of their investment; the Shares offer no guaranteed income and no capital protection; and an investment in the Shares is compatible only with investors who do not need a guaranteed income or capital protection, who (either alone or in conjunction with an appropriate financial or other adviser) are capable of evaluating the merits and risks of such an investment and who have sufficient resources to be able to bear any losses that may result therefrom. The Target Market Assessment is without prejudice to the requirements of any contractual, legal or regulatory selling restrictions in relation to the Offer. Furthermore, it is noted that, notwithstanding the Target Market Assessment, the Managers will only procure investors who meet the criteria of professional clients and eligible counterparties. For the avoidance of doubt, the Target Market Assessment does not constitute: (a) an assessment of suitability or appropriateness for the purposes of MiFID 2; or (b) a recommendation to any investor or group of investors to invest in, or purchase, or take any other action whatsoever with respect to the Shares. Each distributor is responsible for undertaking its own target market assessment in respect of the Shares and determining appropriate distribution channels.

PRESENTATION OF FINANCIAL AND OTHER INFORMATION

General

The content of this Prospectus is not to be considered or interpreted as legal, financial or tax advice. It is not intended to provide the basis for any credit or other evaluation and should not be considered as a recommendation by any of the Bank, the members of the Board of Directors, the Executive Committee, the Selling Shareholder, any of the Managers or any of their respective representatives that any recipient of this Prospectus should purchase any Offer Shares. The Managers are party to various agreements pertaining to the Offering and have entered or may enter into financing arrangements with the Bank, but this should not be considered as a recommendation by them to invest in the Offer Shares. Each prospective investor should consult his own stockbroker, bank manager, lawyer, auditor or other financial, legal or tax advisors before making any investment decision with respect to the Offer Shares to, among other things, consider such investment decision in light of his or her personal circumstances and to determine whether or not such prospective investor is eligible to purchase the Offer Shares.

Potential investors should rely only on the information contained in this Prospectus and any prospectus supplements announced in accordance with the provisions of the Prospectus Act. The Bank will not undertake to update this Prospectus, unless required pursuant to the provisions of the Prospectus Regulation, and therefore potential investors should not assume that the information in this Prospectus is accurate as at any date other than the date of this Prospectus. No person is, or has been, authorised to give any information or to make any representation in connection with the Offering, other than as contained in this Prospectus and, if given or made, any such other information or representation must not be relied upon as having been authorised by the Bank, the members of the Board of Directors, the Executive Committee, the Selling Shareholder, the Financial Advisors, any of the Managers or any of their respective representatives. The delivery of this Prospectus at any time after the date hereof will not, under any circumstances, create any implication that there has been no change in the affairs of the Bank since the date hereof or that the information contained herein is correct as at any time subsequent to such date.

No representation or warranty, express or implied, is made or given by or on behalf of the Managers or any of their affiliates or any of their respective directors, officers or employees or any other person, as to the accuracy, completeness or fairness of the information or opinions contained in this Prospectus, and nothing in this Prospectus shall be relied upon as a promise or representation by the Managers or any of their respective affiliates as to the past or future. None of the Managers accepts any responsibility whatsoever for the content of this Prospectus or for any other statements made or purported to be made by either itself or on its behalf in connection with the Bank, the Selling Shareholder, the Offering or the Offer Shares. Accordingly, the Managers disclaim, to the fullest extent permitted by applicable law, all and any liability whether arising in tort, contract or otherwise, which they might otherwise have in respect of this Prospectus and/or any such statement.

The Managers are acting exclusively for the Bank and the Selling Shareholder and no one else in connection with the Offering. They will not regard any other person (whether or not a recipient of this Prospectus) as their clients in relation to the Offering and will not be responsible to anyone other than the Bank and the Selling Shareholder for providing the protections afforded to their clients or for giving advice in relation to the Offering and the listing or any transaction, matter or arrangement referred to herein.

In connection with the Offering, the Managers and any of their respective affiliates, acting as investors for their own accounts, may acquire the Offer Shares and in that capacity may retain, purchase, sell, offer to sell or otherwise deal for their own accounts in such Offer Shares and other securities of the Bank or related investments in connection with the Offering or otherwise.

Accordingly, references in this Prospectus to the Offer Shares being offered, acquired, placed or otherwise dealt in should be read as including any offer to, or acquisition, dealing or placing by, the Managers and any of their affiliates acting as investors for their own accounts. None of the Managers intends to disclose the extent of any such investment or transactions otherwise than in accordance with any legal or regulatory obligations to do so.

The Offer Price Range is indicative only and the Offer Price may be set within, above or below the Offer Price Range. The Offer Price and the number of the Offer Shares to be included in the Offering will be determined upon the finalisation of the book-building period (expected to occur on or about 15 June 2021) and will be announced through the publication of an announcement. In the event that the Offer Price is set above or below the Offer Price Range, the Bank will publish a supplement to this Prospectus in accordance with the provisions of the Prospectus Act.

Supplements

If a significant new factor, material mistake or material inaccuracy relating to the information included in this Prospectus which may affect the assessment of the Offer Shares arises or is noted between the date of this Prospectus being approved by the FSA and the end of the Offering Period or, if applicable, the start of trading on Nasdaq Iceland, or if the Offer Price is determined above or below the Offer Price Range, then a prospectus supplement shall be prepared, approved and published in accordance with Article 23 of the Prospectus Regulation and Article 5 of the Prospectus Act. The summary of the Prospectus and any translation thereof shall also be supplemented as applicable.

Investors who have already agreed to purchase the Offer Shares before such a supplement is published shall have the right, exercisable within two business days following the publication of a supplement, to withdraw their acceptances, provided that the significant new factor, material mistake or material inaccuracy referred to above arose or was noted before the closing of the Offering Period or delivery of the Offer Shares, whichever occurs first.

Statements contained in any such supplement (or contained in any document incorporated by reference therein) shall, to the extent applicable, whether expressly, by implication or otherwise, be deemed to modify or supersede statements contained in this Prospectus. Any statement so modified or superseded shall, except as so modified or superseded, no longer constitute a part of this Prospectus. For the avoidance of doubt, references in this paragraph to any supplement being published by the Bank do not include the pricing statement.

Stabilisation

IN CONNECTION WITH THE OFFERING AND TO THE DEGREE PERMITTED BY APPLICABLE LAW, LANDSBANKINN HF., AS STABILISING MANAGER, OR ANY OF ITS AGENTS, ON BEHALF OF THE MANAGERS, MAY (BUT WILL BE UNDER NO OBLIGATION TO), ENGAGE IN TRANSACTIONS THAT STABILISE, MAINTAIN OR OTHERWISE AFFECT THE PRICE OF THE SHARES FOR UP TO 30 DAYS FROM THE COMMENCEMENT OF TRADING ON NASDAQ ICELAND. SPECIFICALLY, THE MANAGERS MAY OVER-ALLOT SHARES OR EFFECT OTHER TRANSACTIONS WITH A VIEW TO SUPPORTING THE MARKET PRICE OF THE SHARES AT A HIGHER LEVEL THAN THAT WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. THE STABILISING MANAGER AND ITS AGENTS ARE NOT REQUIRED TO ENTER INTO SUCH TRANSACTIONS, AND SUCH TRANSACTIONS MAY BE EFFECTED ON ANY SECURITIES MARKET, OVER-THE-COUNTER MARKET, STOCK EXCHANGE OR OTHERWISE AND MAY BE UNDERTAKEN AT ANY TIME DURING THE PERIOD COMMENCING ON THE FIRST DAY OF TRADING IN THE SHARES ON NASDAQ ICELAND AND ENDING NO LATER THAN 30 CALENDAR DAYS THEREAFTER. HOWEVER, THERE WILL BE NO OBLIGATION ON THE STABILISING MANAGER OR ANY OF ITS AGENTS TO EFFECT STABILISING TRANSACTIONS, AND NO ASSURANCE CAN BE GIVEN THAT STABILISING TRANSACTIONS WILL BE UNDERTAKEN. SUCH STABILISATION, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME WITHOUT PRIOR NOTICE. IN NO EVENT WILL MEASURES BE TAKEN TO STABILISE THE MARKET PRICE OF THE SHARES AND ABOVE THE OFFERING PRICE. THE STABILISING MANAGER WILL DISCLOSE INFORMATION ON STABILISATION TRANSACTIONS UNDER THE OFFERING AS REQUIRED BY THE SECURITIES TRANSACTION ACT AND REGULATION NO. 630/2005 ON INSIDER INFORMATION AND MARKET ABUSE, AS AMENDED.

Potential Conflict of Interest

The Managers, the Financial Advisors and/or their respective affiliates have from time to time engaged, and may in the future engage, in commercial banking, investment banking and financial advisory and ancillary transactions in the ordinary course of their business with the Group (or any parties related to the Group) for which they have received or may receive customary compensation, fees and/or commissions. These services may include issuing or creating and trading in the Group's securities and financial products, acting with the Group in debt or equity syndicates, providing investment banking, corporate banking or lending services with and to the Group, credit and rate flows with the Group, securities financing set-ups, acting as payments provider for the Group, holding cash management accounts for the Group, providing treasury services, such as repo, securities finance and portfolio management for liquidity management purposes and providing trading services, such as credits, rates and foreign exchange, commercial paper and certificate of deposit services and fixed income and treasury sales. In addition, the Managers, ABN AMRO and/or their respective affiliates, in the ordinary course of their business, hold, have held and/or may in the future hold a broad array of investments and actively trade the Group's debt and equity securities (or related derivative securities) and financial instruments (including bank loans) for their own account and for the accounts of their customers, including securities in relation to which the Managers or ABN AMRO may be exercising voting power over the Group's securities on behalf of third parties. The Managers, ABN AMRO and/or their respective affiliates may also make investment recommendations and/or publish or express independent research views in respect of securities and/or financial instruments of the Group, its affiliates and/or affiliates of the Selling Shareholder and may hold or recommend to clients that they acquire, long and/or short positions in such securities and instruments.

In connection with the Offering, each of the Managers and/or any of their respective affiliates, acting as an investor for its own account, may take up the Offer Shares and, in that capacity may retain, purchase or sell for its own account such Offer Shares or related investments and may offer or sell such Offer Shares or related investments otherwise than in connection with the Offering. Accordingly, references in this Prospectus to the Offer Shares being offered or placed should be read as including any offering or placement of the Offer Shares to any of the Managers and/or any of their respective affiliates acting in such capacity. In addition, certain of the Managers and/or their respective affiliates may enter into financing arrangements (including swaps) with investors in connection with which the Managers and/or their respective affiliates may from time to time acquire, hold or dispose of the Offer Shares. The Managers do not intend to disclose the extent of any such investment or transactions otherwise than in accordance with any legal or regulatory obligation to do so. As a result of acting in the capacities described above, the Managers may have interests that may not be aligned, or could potentially conflict, with interests of the investors in the Offer Shares and the Group.

In addition, Íslandsbanki will act as a Joint Global Coordinator and Joint Bookrunner in this Offering, and in such role, it may have interests that may not be aligned, or could potentially conflict with, interests of the rest of the Group.

Presentation of Financial Information

The consolidated financial information as at and for the years ended 31 December 2020, 2019 and 2018 has, unless otherwise stated and except for the below, been derived from the Bank's audited consolidated financial statements for the financial years ended 31 December 2020, 2019 and 2018, included in "*Consolidated Financial Statements*" (the "**Annual Financial Statements**"), prepared in accordance with the IFRS, and additional requirements set forth in the Annual Accounts Act, the Financial Undertakings Act and Rules No. 532/2003 on Accounting for Credit Institutions. Financial information in this Prospectus is presented on a consolidated basis unless otherwise indicated.

The selected condensed consolidated interim financial information as at and for the three months ended 31 March 2021 has, unless otherwise stated, been derived from the Bank's unaudited condensed consolidated interim financial statements for the three months ended 31 March 2021, prepared in accordance with International Accounting Standard 34, "Interim Financial Reporting," as adopted by the European Union, the Annual Accounts Act, the Financial Undertakings Act and Rules No. 532/2003 on Accounting for Credit Institutions.

The Annual Financial Statements have been audited by Ernst & Young ehf., the independent auditor of the Bank, and the unaudited condensed consolidated interim financial statements for the three months ended 31 March 2021 have been reviewed by Ernst & Young ehf. The respective audit reports and review report are included in this Prospectus.

Non-IFRS Information

This Prospectus contains certain financial measures that are not defined or recognised under IFRS, exclude amounts that are included in, or include amounts that are excluded from, the most directly comparable measure calculated and presented in accordance with IFRS, or are calculated using financial measures that are not calculated in accordance with IFRS.

The Bank's non-IFRS measures comprise liquidity coverage ratio, net stable funding ratio, CET1 ratio, loan-to-deposit ratio, REA density, net interest margin, return on equity, cost-to-income ratio, total capital ratio, deposit yield, loan-to-value on mortgages to individuals, over-collateralisation, leverage ratio, dividend ratio, cost of risk, asset encumbrance ratio, long term annual credit loss (collectively, the "**Non-IFRS Information**").

The Bank uses these indicators in its business operations, among other things, to evaluate the performance of its operations, to develop budgets and to measure the Bank's performance against those budgets. The Bank believes the Non-IFRS Information to be useful supplemental tools to assist in evaluating operating performance because it considers the Non-IFRS Information to reflect its underlying business performance and believes that these measures provide additional useful information for prospective investors on its performance, enhance comparability from period to period and with other companies and are consistent with how business performance is measured internally.

The Non-IFRS Information and related measures are not measurements of performance or liquidity under IFRS and should not be considered by investors in isolation or as a substitute for measures of earnings, as an indicator of the Bank's operating performance or cash flows from operating activities as determined in accordance with IFRS or otherwise as a substitute for analysis of the Bank's operating results reported under IFRS. The Bank has presented these supplemental measures because they are used by the Bank to monitor the underlying performance of its business and operations. The Non-IFRS Information and related measures may not be comparable to similarly titled measures disclosed by other banks and have limitations as analytical tools. The Bank does not regard the Non-IFRS Information as a substitute for, or superior to, the equivalent measures calculated and presented in accordance with IFRS or those calculated using financial measures that are calculated in accordance with IFRS. The Non-IFRS Information described in this Prospectus is unaudited and has not been prepared in accordance with IFRS or any other generally accepted accounting principles. In addition, the presentation of the Non-IFRS Information is not intended to and does not comply with the reporting requirements of the U.S. Securities and Exchange Commission. None of this financial information is subject to any audit or review by independent auditors.

For definitions of the non-IFRS measures included in the Non-IFRS Information, along with quantitative reconciliations to the most directly comparable amounts reported in accordance with IFRS, see "*Selected Consolidated Financial, Operating and Other Information—Certain Other Financial Information*".

Rounding

Certain figures in this Prospectus, including financial information, have been subject to rounding adjustments. Accordingly, in certain instances (a) the sum or percentage change of such numbers may not conform exactly to the total figure given and (b) the sum of the numbers in a column or row in certain tables may not conform exactly to the total figure given for that column or row.

Currency Presentation

The tables below set forth U.S. dollar versus ISK and euro versus ISK exchange rates as certified by the Central Bank of Iceland. The Bank does not represent that the ISK amounts referred to below could have been or could be converted into U.S. dollars or euro at any particular rate indicated or at any other rate. The rates below may differ from the rates used in "*Consolidated Financial Statements*" and other financial information appearing in this Prospectus.

The table below sets forth the high and low Central Bank of Iceland daily closing mid-rates for U.S. dollar versus ISK for each respective year and the rate at the end of the year. The average amounts set forth below under "Average" are calculated as the average of the Icelandic Central Bank rates for U.S. dollar versus ISK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
		(ISK per U.S. dollar)		
2016	109.97	131.66	120.67	112.82
2017	97.79	116.64	106.78	104.42
2018	98.02	125.43	108.38	116.33
2019	116.64	127.69	122.65	121.10
2020	121.93	147.51	135.27	127.21

The table below sets forth the high and low Central Bank of Iceland rates for U.S. dollar versus ISK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(ISK per U.S. dollar)	
December 2020	125.11	132.19
January 2021	126.54	129.98
February 2021	125.36	130.14
March 2021	124.81	128.96
April 2021	122.35	127.79
May 2021	120.27	125.61

The U.S. dollar versus ISK Central Bank of Iceland exchange rate on 2 June 2021 was ISK 119.89 per U.S.$1.00.

The table below sets forth the high and low Central Bank of Iceland daily closing mid-rates for euro versus ISK for each respective year and the rate at the end of the year. The average amounts set forth below under "Average" are calculated as the average of the Central Bank of Iceland rates for euro versus ISK on the last business day of each month for each respective year.

	Low	High	Average	End of Year
		(ISK per euro)		
2016	118.25	143.08	132.66	119.13
2017	110.00	128.38	120.27	120.05
2018	121.30	142.30	127.17	133.23
2019	132.70	141.90	136.86	135.83
2020	135.90	165.80	155.16	156.10

The table below sets forth the high and low Central Bank of Iceland rates for euro versus ISK for each month during the six full months prior to the date of this Prospectus.

	Low	High
	(ISK per euro)	
December 2020	152.10	158.20
January 2021	155.30	157.20
February 2021	152.90	156.30
March 2021	148.10	153.90
April 2021	148.40	151.90
May 2021	146.50	151.10

The euro versus ISK Central Bank of Iceland exchange rate on 2 June 2021 was ISK 146.10 per EUR 1.00.

Market Data

Certain information contained in this Prospectus relating to the financial services industry in which the Group operates as well as certain economic and industry data and forecasts used, and statements regarding the Group's market position made, in this Prospectus were extracted or derived from other third party reports, market research, government and other publicly available information and independent industry publications, as the case may be, including the research department of the Bank, Statistics Iceland, Eurostat, IMF, OECD, Ministry of Finance, Central Bank of Iceland, Isavia, Icelandic Tourist Board, Nasdaq Iceland, keldan.is, Gallup and annual reports of Arion Bank and Landsbankinn. See "*Industry Overview*" and "*Business Overview*".

While the Bank believes the third-party information included herein to be reliable, the Bank has not independently verified such third-party information, and none of the Bank, the Managers or the Selling Shareholder make any representation or warranty as to the accuracy or completeness of such information as set forth in this Prospectus. The Bank confirms that such third-party information has been accurately reproduced and, as far as the Bank is aware and able to ascertain from information available from those publications, no facts have been omitted which would render the reproduced information inaccurate or misleading. However, the accuracy of such third-party information is subject to availability and reliability of the data supporting such information and neither the information nor the underlying data has been independently verified. Additionally, the industry publications and other reports referred to above generally state that the information contained therein has been obtained from sources believed to be reliable, but that the accuracy and completeness of such information is not guaranteed and, in some instances, these reports and publications state expressly that they do not assume liability for such information. The Bank cannot therefore make any assurances regarding the accuracy and completeness of such information as it has not independently verified such information.

Enforcement of Civil Liabilities

The ability of shareholders in certain countries other than Iceland, in particular in the United States, to bring an action against the Bank may be limited by relevant law. The Bank is a public limited company established under the Public Limited Companies Act, with ID number 491008-0160 in the Register of Enterprises of Iceland and has its registered office in Kópavogur, Iceland.

The Lugano Convention is in force between the European Union and Iceland. The Lugano Convention and protocols 1, 2 and 3 are incorporated into Icelandic law with Act No. 7/2011. Subject to the conditions set forth in the Lugano Convention, it forms the basis on which international jurisdiction of the courts is determined, facilitates recognition of foreign judgements and sets out an expeditious procedure for securing the enforcement of judgements in Iceland.

Iceland, Denmark, Finland, Norway and Sweden have been parties to a convention on the recognition and enforcement of judgements since 1932 and to the Nordic Judgements Conventions. The Lugano Convention supersedes the Nordic Judgements Convention, subject to certain exceptions set forth in the Lugano Convention.

All members of the Board of Directors, the Executive Committee and other officers named herein are residents of countries other than the United States. All or a substantial portion of the assets of these persons are located outside the United States. The assets of the Bank are predominantly located outside the United States. As a result, it may be impossible or difficult for investors to effect service of process within the United States upon such persons or the Bank or to enforce in U.S. courts a judgement obtained in courts of other jurisdictions against them or the Bank.

The United States and Iceland do not currently have a treaty providing for reciprocal recognition and enforcement of judgements, other than arbitration awards according to the New York Convention 1958, in civil and commercial matters. Accordingly, a judgement rendered by a court in the United States will not be recognised and enforced by the Icelandic courts. It is a general principle of Icelandic law that foreign judgements do not have legal effect in Iceland unless such effect is provided for in legislation. Because Icelandic law does not provide that judgements rendered by a court in the United States will have specific legal effects in Iceland, such judgements will have limited relevance to the resolution of claims in Icelandic courts. Judgements rendered by a court in the United States can provide guidance on the interpretation of U.S. law to the extent that it governs the subject of the dispute and has probative value as to disputed facts, if the jurisdiction of the U.S. court has been based on grounds which are internationally acceptable, the defendant has been given a reasonable opportunity to defend the claims made and proper legal procedures have been observed and except to the extent that the foreign judgement contravenes Icelandic public policy.

No Incorporation of Website Information

The Bank's website is www.islandsbanki.is. Neither the contents of the Bank's website, nor any other website, forms a part of, nor is to be considered incorporated into, this Prospectus.

Forward-Looking Statements

This Prospectus contains forward-looking statements that reflect the Bank's intentions, beliefs or current expectations and projections about its future business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies and opportunities and the markets in which it operates. Forward-looking statements involve all matters that are not historical facts. The Bank has tried to identify forward-looking statements by using words such as "may", "will", "would", "could", "should", "expects", "intends", "estimates", "anticipates", "projects", "believes", "hopes", "seeks", "plans", "aims", "objective", "potential", "goal", "strategy", "target", "continue", "annualised" and similar expressions or negatives thereof or other variations thereof or comparable terminology or by discussions of strategy that involve risks and uncertainties. Forward-looking statements may be found principally in sections of this Prospectus titled "*Risk Factors*", "*Industry Overview*", "*Business Overview*", "*Operating and Financial Review*" and "*Shares and Share Capital—Dividends and Dividend Policy*" as well as elsewhere.

Forward-looking statements are based on the Bank's beliefs, assumptions and expectations regarding future events and trends that affect the Bank's future performance, considering all information currently available to the Bank, and are not guarantees of future performance. These beliefs, assumptions and expectations can change as a result of possible events or factors, not all of which are known to the Bank or are within its control. If a change occurs, the Bank's business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies or opportunities may vary materially from those expressed in, or suggested by, these forward-looking statements. In addition, forward-looking estimates and forecasts reproduced in this Prospectus from third-party reports could prove to be inaccurate. A number of important factors could cause actual results or outcomes to differ materially from those expressed in any forward-looking statement as a result of risks and uncertainties facing the Bank. Such risks, uncertainties and other important factors include, but are not limited to, those listed in the section of this Prospectus titled "*Risk Factors*".

The following include some but not all of the factors that could cause actual results or events to differ materially from the anticipated results or events:

- deterioration of the economic conditions or the banking system in Iceland, either as a result of political or economic factors, either domestic or international;
- exposure to Iceland's key industry sectors, in particular tourism, seafood, aluminium, energy and real estate;
- an adverse shift in public sentiment and potential political or legislative action;
- exposure to liquidity, maturity, foreign exchange, and market funding risks and various other typical financial institution market risks relating to interest rates, equity pricing and inflation;
- regulatory changes or precedence in respect of interest and indexation;
- existing customer loan portfolio exposure to problem and impaired loans;
- costs and competitive disadvantages resulting from the Bank Levy and other taxes;
- domestic economic constraints on near-term growth;
- failure to implement the Bank's strategy or failure to achieve the anticipated benefits of this strategy;
- exposure to existing and increasing competition in Iceland as Iceland's economy recovers;
- regulatory and legal risks inherent in the Bank's businesses;
- ongoing legal proceedings and investigations by government authorities;
- failure or breach of the Bank's information technology systems;
- unauthorised disclosure of confidential information and any resulting liability, litigation and reputational damage;
- restrictions under the Capital Controls on the Bank's operations;
- potential inability to recruit or retain experienced personnel or key members of the Executive Committee;
- a credit rating downgrade or change in outlook;
- various operational risks, including risk of systems failures, human error, regulatory breaches and employee misconduct;
- damage to the reputation of the Bank, its subsidiaries or its shareholders;
- exposure to unidentified, unanticipated or incorrectly quantified risks as a result of risk management methods;
- reliance on third-party service providers;
- violation of anti-money laundering or anti-bribery regulations;

- adverse changes to the Capital Requirements Directives;
- restriction, suspension or termination of relationships with key card scheme operators;
- failure of the Group to sustain or increase its level of assets under management;
- pressure on fee margins;
- incurrence of unforeseen liabilities from prior and future acquisitions and disposals;
- inadequate insurance coverage; and
- inadequate implementation by Iceland of the EEA rules.

Should one or more of these risks or uncertainties materialise or should any of the assumptions underlying the above or other factors prove to be incorrect, the Bank's future business, results of operations, financial condition, liquidity, performance, prospects, anticipated growth, strategies or opportunities could differ materially from those described herein as currently anticipated, believed, estimated or expected.

Investors or potential investors should not place undue reliance on the forward-looking statements in this Prospectus. The Bank urges investors to read the sections of this Prospectus titled "*Risk Factors*", "*Industry Overview*", "*Business Overview*" and "*Operating and Financial Review*" for a more complete discussion of the factors that could affect the Bank's future performance and the markets in which it operates. In light of the possible changes to the Bank's beliefs, assumptions and expectations, the forward-looking events described in this Prospectus may not occur. Additional risks currently not known to the Bank or that the Bank has not considered material as at the date of this Prospectus could also cause the forward-looking events discussed in this Prospectus not to occur. Forward-looking statements involve inherent risks and uncertainties and speak only as at the date they are made. The Bank undertakes no duty to and will not necessarily update any of the forward-looking statements in light of new information or future events, except to the extent required by applicable law.

BACKGROUND AND REASONS AND USE OF PROCEEDS

Background and Reasons

On 29 January 2021, the Ministry of Finance announced the Minister's decision to initiate a sale process for certain of the Selling Shareholder's Shares in the Bank based on a proposal made by the Selling Shareholder on 17 December 2020 (the "**Minister's Decision**"). On 21 December 2020, the Ministry of Finance submitted a memorandum setting out the main objectives and features of the Offering to the Budget Committee and the Economic Affairs and Trade Committee of the Althingi, and the Central Bank of Iceland. The two committees submitted their reports on the proposed sale process to the Ministry of Finance on 20 January 2021 in which each of the Budget Committee and the Economic Affairs and Trade Committee of the Althingi recommended that work begin on preparation of the Offering and a listing of the Bank on the Nasdaq Iceland.

The Central Bank of Iceland stated in its report on the planned sales process, which was released on 15 January 2021, that the equality of foreign and domestic investors could be ensured as the Capital Controls and restrictions on Offshore Króna Assets had been lifted in most respects and that the sale would have a limited impact on the foreign exchange market, the foreign exchange reserves of the Central Bank of Iceland and money supply if the sale of a part of the Selling Shareholder's Shares was based on the proposal made by the Selling Shareholder.

In the Minister's Decision, the Ministry of Finance recommended that the Selling Shareholder in consultation with it, that the terms and conditions of the Offering reflect the views of the two parliamentary committees, e.g., concerning the size of the Offering, minimum and maximum subscriptions, competition in financial markets and breadth of the shareholder base after the offering.

The proposed sale process is in accordance with the provisions of Act No. 88/2009 and Act No. 155/2012, the Government's Ownership Policy, the government of Iceland's collaboration agreement and the Minister's Decision, which incorporates the views of the two parliamentary committees.

In respect of Act no. 155/2012 the Selling Shareholder will aim to be guided by the following principles:

- achieve the highest price or the market price for holdings;
- put emphasis on an open sales process, transparency and objectivity;
- treat investors equally and fairly in terms of conditions;
- promote active and normal competition in financial markets.

In respect of Act no. 88/2019 the Selling Shareholder will aim to be guided by the following principles:

- achieve dispersed ownership following a public sale;
- revitalize domestic financial markets and competition therein;
- ensure transparency in all decision-making and active information disclosure to the general public.

The Minister's Decision also references other objectives concerning the risks relating to the government's holdings in financial undertakings, competition in financial markets, the financial return on holdings, the expansion of investment alternatives for individual and institutional investors and the reduction in government debt or growth in socially beneficial investments.

In the Minister's Decision, the Ministry of Finance further requested that the Selling Shareholder assess whether it would be in furtherance of the objectives of the Government's Ownership Policy concerning the maximisation of financial benefits of ownership and sale of shares, if the Bank paid dividends higher than ISK 3 to 4 billion prior to the Offering, and if not in furtherance of such objective, the Selling Shareholder was requested to provide adequate supporting arguments. As requested by the Selling Shareholder, the Board of Directors of the Bank provided its opinion on whether it would be feasible and serve the interest of the Bank to distribute equity to the Selling Shareholder prior to the Offering. In its opinion, the Board of Directors indicated that it would be reasonable to postpone all additional equity distribution until the uncertainty resulting from the COVID-19 pandemic has been reduced.

The Board of Directors and the Executive Committee are of the opinion that the time is appropriate for a listing of the Bank on Nasdaq Iceland. The Board of Directors and the Executive Committee consider the Offering and listing of the Offer Shares on Nasdaq Iceland to be the next logical step for the Bank. The Offering and the listing of the Offer Shares on Nasdaq Iceland will expand the shareholder base and enable the Bank to access the Icelandic and other international capital markets.

For further details on the Offering, see "*Terms and Conditions of the Offering*".

Use of Proceeds

The Bank will not receive any proceeds from any sale of the Offer Shares by the Selling Shareholder, all of which will be paid to the Selling Shareholder. The gross proceeds from the Offering to be received by the Selling Shareholder will be approximately ISK 42,614 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised).

The aggregate underwriting commissions, other fees and expenses to be paid by the Selling Shareholder in connection with the Offering are expected to be up to approximately ISK 1,378 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range and the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised). The total cost borne by the Bank is estimated to be ISK 750 million and consists of costs associated with the scrutiny and approval of the Prospectus including paid overtime to employees, the Nasdaq Iceland listing fees, fees to its advisors, along with other costs directly associated with the admittance to trading.

The net proceeds to be received by the Selling Shareholder will be approximately ISK 41,236 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised).

See "*Plan of Distribution and Transfer Restrictions*".

Responsibility Statements

The Bank and the Board of Directors are responsible for the content of this Prospectus. The Bank and the Board of Directors hereby declare that, having taken all reasonable care to ensure that such is the case, the information in this Prospectus is, to the best of the Bank's and the Board of Directors' knowledge, in accordance with the facts and contains no omission likely to affect its import.

Kópavogur, 7 June 2021

For and on behalf of the Bank

Birna Einarsdóttir

Birna Einarsdóttir, CEO of Íslandsbanki

For and on behalf of the Board of Directors of the Bank

Hallgrímur Snorrason

Hallgrímur Snorrason, Chairman of the Board of Directors of the Bank

The board of directors of the Selling Shareholder declares that, having taken all reasonable care to ensure that such is the case, the information in this Prospectus regarding the Offer Price Range, the Offer Price, the timing of the Offering, including payment and delivery of the Offer Shares, the description of the lock-up applicable to its Shares and the fees payable by it in relation to the Offering is, to the best of its knowledge, in accordance with the facts and contains no omission likely to affect its import. The Selling Shareholder does not accept any responsibility for any other information contained in this Prospectus, nor has it separately verified any such other information.

Reykjavík, 7 June 2021

For and on behalf of the Board of Directors of the Selling Shareholder

Lárus L. Blöndal, Chairman of the Board of Directors of the Selling Shareholder

Independent Auditor

The consolidated financial statements of the Bank for the years ended 31 December 2020, 2019 and 2018 and for years then ended included in this Prospectus, have been audited by Ernst & Young ehf., independent auditors, as stated in their reports appearing herein. Ernst & Young ehf.'s audit reports were signed by Margrét Pétursdóttir, Certified public accountant and member of the Icelandic Institute of State Authorised Public Accountants.

OFFER STATISTICS

Offer Price Range (per Share)[(1)]	ISK 71 to ISK 79
Number of Shares issued and outstanding	2,000,000,000
Number of the Existing Offer Shares to be sold in the Offering[(2)]	Up to 636,363,630
Percentage of the issued share capital expected to be sold in the Offering[(2)]	Up to 31.8%
Maximum number of Over-Allotment Shares	63,636,363
Estimated gross proceeds of the Offering[(3)]	ISK 42,614 million
Estimated net proceeds of the Offering[(3)(4)]	ISK 41,236 million
Expected market capitalisation of the Bank at the Offer Price[(5)]	ISK 150 billion

(1) The Offer Price may be set within, above or below the Offer Price Range. To the fullest extent permitted by law, applications received under the Offer are irrevocable, except as set out in this Prospectus, and are based on the amount the applicant wishes to invest and not the number of the Shares or the Offer Price. The Offer Price will be set in ISK. It is expected that the Pricing Statement containing the Offer Price and the number of the Shares which are the subject of the Offer will be published on or about 15 June 2021.

(2) Assumes that Over-Allotment Option is not exercised.

(3) Assumes that the Offer Price is set at the mid-point of the Offer Price Range, the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised.

(4) After deduction of commissions and expenses payable by the Selling Shareholder of ISK 1,378 million. The Bank will not receive any portion of the proceeds from the Offering. No expenses will be charged to investors by the Company or the Selling Shareholder.

(5) Calculated based on the number of Shares outstanding and assumes that the Offer Price is set at the mid-point of the Offer Price Range.

EXPECTED TIMETABLE OF PRINCIPAL EVENTS

Each of the times and dates (other than the publication date of the Prospectus) in the table below is indicative only and may be subject to change.

Prospectus published, announcement of the Offer Price Range	7 June 2021
Opening of the Offering	09:00 GMT on 7 June 2021
Closing of the Offering	12:00 GMT on 15 June 2021
Determination and announcement of the Offer Price and number of the Offer Shares	15 June 2021
Results of allocations under the Offer notified to investors	16 June 2021
Final due date for payment by investors	21 June 2021
Settlement Date(1)	22 June 2021
Admission to trading and commencement of trading in Shares on Nasdaq Iceland	09:30 GMT on 22 June 2021
End of stabilisation period	22 July 2021

(1) Delivery of Offer Shares is expected in most cases to occur by the Settlement Date. However, because the final due date for payment of the allocated Shares is set for 21 June 2021, and paid Offer Shares are expected to be delivered to the investors within two business days after payment is received, the estimated final date for delivery of the Offer Shares to investors is no later than 23 June 2021.

INDUSTRY OVERVIEW

This Prospectus contains statistics, data and other information relating to the banking industry in which the Bank operates. Where indicated, the Bank has extracted or derived certain economic and industry data from third-party reports, market research, government reports and other publicly available information. Although the information has been accurately reproduced and the Bank believes the sources are reliable, none of the Bank, the Managers or the Selling Shareholder has independently verified and cannot give any assurance with respect to the accuracy and completeness of such information. As far as the Bank is aware and able to ascertain from other information published by such sources, no fact has been omitted which would render the reproduced information inaccurate or misleading.

The Icelandic Economy

Attractive society demographics and economy with very high GDP per capita

Iceland has a population of approximately 360,000 people. The population has a high standard of living; in 2020, Iceland had the seventh-highest GDP per capita in the world at approximately U.S.$60,000 (*source: IMF*), a result of factors such as a skilled workforce, a strong institutional framework and high economic freedom. The unemployment rate in Iceland, which has historically been low, measured on average 4.7% from 2010 to 2019. This is significantly lower than the average in the Eurozone (*source: Statistics Iceland, OECD*), and has contributed to comparatively low economic inequality in the country.

Iceland is a nation rich in natural resources, sustainable fisheries and renewable energy, and it also ranks highly on a range of global environment, social and governance ("**ESG**") metrics, including:

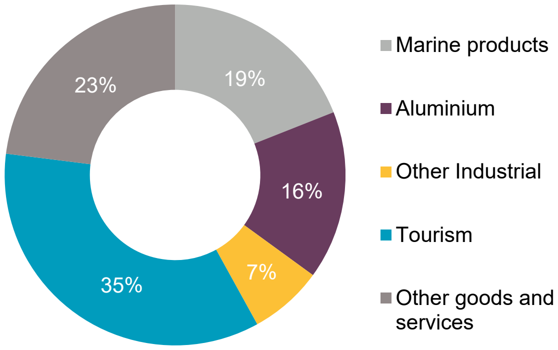
- First in gender equality (*source: World Economic Forum*);
- First in Green Future Index (*source: MIT Technology Review*);
- First in the Global Peace Index (*source: Vision of Humanity*);
- First among European countries for frequency of internet usage (*source: Eurostat*);
- Second in the Democracy Index (*source: The Economist*);
- Sixth in the Social Progress Index (*source: Social Progress Imperative*); and
- Sixth in the Human Development Index (*source: United Nations Development Program*).

Iceland's key ESG objectives are to have net zero emissions by 2040 and to follow its implementation of Europe's 2030 Climate Action Plan and the UN's 2030 Agenda for Sustainable Development.

The country has a tradition of strong social cohesion, with a coalition government and high trust in the government. Economic inequality is low compared to peers, with a Gini coefficient of 0.24 as at 2020 (*source: OECD*).

Iceland's export sector, which has shifted from goods to services as tourism to the country has grown, has been the main driver of growth for its increasingly diversified economy; the biggest export areas are tourism, seafood, energy and other industrial goods and services. Until 2018, Iceland experienced an accelerated growth in tourism, with an annual increase in the number of tourists of 24% in 2017 and 6% in 2018, which contributed to the strength of its GDP throughout this period. However, the number of tourists declined by 14% in 2019, largely driven by the collapse of the second largest domestic airline in Q1 that year, and 76% in 2020 as COVID-19 significantly impacted the sector (*source: Statistics Iceland, Isavia*). In 2020, exports contributed approximately 34% to Iceland's GDP, with the tourism and seafood industry sectors amounting to 12% and 27% of exports, respectively (*source*: *Statistics Iceland*).

The graph below presents export contributions by industry in 2019 (*Source: Statistic Iceland, Íslandsbanki Research, the Central Bank of Iceland, OECD*).



Key challenges for Iceland in the coming years will be to increase the diversification of its exports and for the government to continue to spend on infrastructure and education to both meet tourism demands and to better equip the economy to meet the challenges in coming years.

Resilience during COVID-19 with strong upside prospects

The Bank believes that Iceland will be a chief beneficiary of the reopening of the global economy once the COVID-19 pandemic ends. Iceland saw a 6.6% decline in GDP in 2020, compared to the 6.8% average decline in the European Union and 9.9% decline in the United Kingdom (*source: Statistics Iceland, IMF*). The COVID-19 pandemic also led to a spike in unemployment in Iceland to 7.9% in 2020 (*sources: Statistic Iceland, ISB Research, the Central Bank of Iceland, OECD*).

The Icelandic government offered an effective policy response against the COVID-19 pandemic, which has allowed Iceland's current COVID-19 status to be among the best in Europe according to European Centre for Disease Control statistics as at 1 June 2021, when Iceland had a vaccination rate of 28.5% and ranked second in Europe in terms of vaccination rates. Measures implemented by the Icelandic government included furlough schemes and financial support for companies suffering from loss of turnover. Overall, Iceland experienced fewer restrictions on domestic activities than most of Europe, with domestic demand holding up well as a result.

The Bank's research department forecasts strong upside potential for Iceland as tourism is expected to return gradually, and there could be a two-fold benefit, as both tourism and transit flights recommence due to Iceland's unique geographic location. In this respect, it forecasts Icelandic real GDP growth of 2.7% in 2021, 4.9% in 2022 and 2.9% in 2023.

Solid economic foundations supporting future growth

Iceland is a growing economy with an average real GDP growth per year of 3.5% from 2011 to 2019 and a healthy investment-to-GDP ratio of 18.6% on average over the same period (*source: Statistics Iceland*). Iceland has a GDP of EUR 19 billion, which makes it currently the smallest economy among member countries of the Organisation for Economic Co-operation and Development (OECD). Whilst Iceland was one of the least affluent countries in Western Europe until the middle of the twentieth century, there was a rapid upswing in the Icelandic economy beginning in the middle of the century that continued through to the second half of 2008, when it suffered from a banking and currency crisis as part of the wider global financial crisis. Iceland's economy has subsequently seen considerable growth over the last decade as part of its sustained recovery from the crisis; real GDP in Iceland increased in each of 2019, 2018 and 2017 by 2.6%, 4.7% and 4.2%, respectively.

Government gross debt as a percentage of GDP has been decreasing since its peak of 138.2% of GDP in 2011, measuring at 68.3% in 2019. Private debt levels are also lower than in 2008, having come down significantly since 2010, and, more generally, than those in other Nordic countries. However, the IMF projects that, due to the impact of COVID-19, this will increase from 79.9% in 2020 to 88.7% in 2023 (*source: Statistics Iceland, IMF*), although the Central Bank of Iceland predicts that this increase will be less marked than other developed economies.

Iceland has a strong framework for financial markets, including credibility in economic policy and fully autonomous operation with access to a complete macroeconomic toolbox at times of crisis. Iceland's strong credit ratings of AA/Aa2 with S&P Global, Fitch and Moody's reflect the strength of the Icelandic economy and healthy public debt levels. Successful policy and solid growth prospects in Iceland are reflected in Iceland's upward sloping yield curve, with robust recovery expectations creating a favourable rate environment for banking.

Strong current account surplus and net external position

Iceland has maintained a robust current account surplus, which stood at 1.1% of GDP in 2020, and a positive net international investment position of 35% GDP as at and for the year ended 31 December 2020 (*source: The Central Bank of Iceland*). Despite a fall in GDP, a surplus remained due to decreasing imports and increased public consumption, softening the impact of the pandemic in this regard. Iceland's diverse export profile has helped to increase its resilience in this respect. Depreciation of the Icelandic Króna is managed to a degree by currency interventions to facilitate recovery without causing economic instability, where the Central Bank of Iceland has been willing to use its strong foreign currency reserves to decrease volatility in the Icelandic Króna, most recently during the COVID-19 pandemic.

Labour and housing markets remain resilient

Iceland has a high labour market participation rate at 89%, which is characterised by a relatively young population, with a median age of 36.5 years, compared to an EU average of 43.3 years, and 45% of the work force having a university degree or equivalent (*source: Eurostat, OECD*).

The residential housing market in Iceland has remained affordable primarily as a result of wage growth, in terms of rising real wages. The market has continued to rise as a result of households' strong financial positions, attractive mortgage rates and a limited supply of new homes.

The Banking Sector

Iceland has a highly concentrated and stable banking sector, which is supported by (and indeed supports) Iceland's growing economy; it is comprised of three main banks (the Bank, Arion Bank and Landsbankinn), which have high overall market shares in the market for both corporate loans (due to relatively small corporate bond market) and mortgages where the Housing Financing Fund is winding down. Other banks include Kvika (primarily an investment bank) and four small savings banks in rural area. Pension funds have a large presence as customers and buyers of bank and corporate debt, as well as competing in mortgages. The three main banks are all rated BBB / Stable / A-2 by S&P Global.

Certain government-imposed Capital Controls, which limited the ability of the Icelandic population and Icelandic corporates to buy or sell foreign currency, were largely lifted in March 2017. However, certain restrictions remain: mainly restrictions on derivatives trading for purposes other than hedging. The Icelandic banks each have the following characteristics:

- relatively simple balance sheets, with the size of the balance sheets of the three main Icelandic banks as a percentage of Icelandic GDP reducing from approximately 702% as at 31 December 2007 to approximately 164% as at 31 December 2020, and foreign lending as a proportion of total lending reducing from approximately 45% as at 31 December 2007 to approximately 5% as at 31 December 2020 (*source: aggregated balance sheets of the Bank, Arion Bank and Landsbankinn*);

- primarily domestic focus;

- mainly deposit-funded;

- strongly capitalised, with a relatively high average CET1 ratio of 21.6% and an average leverage ratio of 14.5% as at 31 December 2020 compared to Nordic and other EU banks (*source: the European Banking Authority*); and

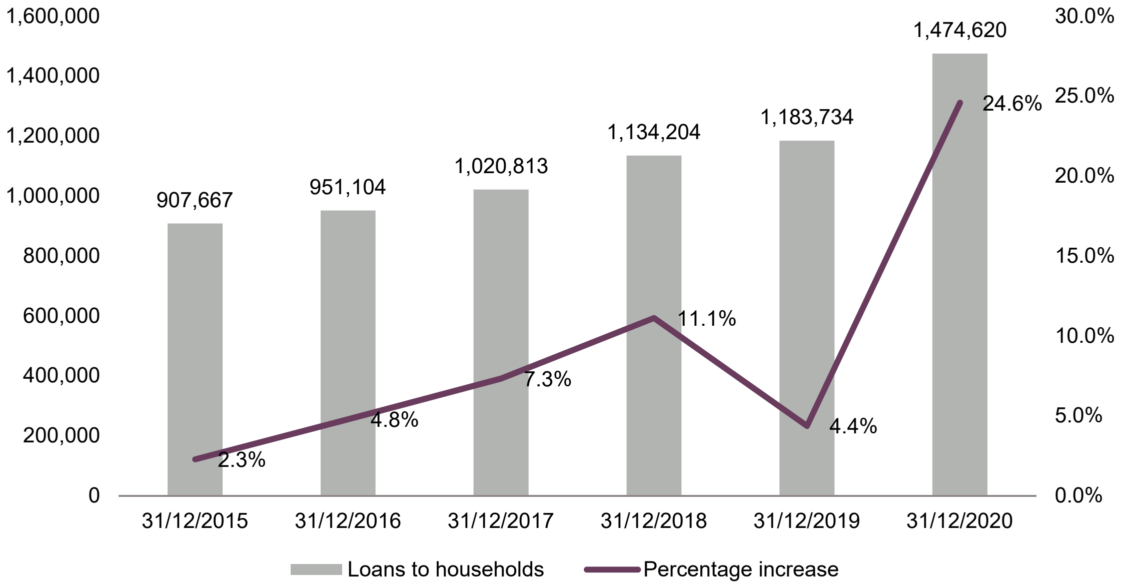
- focus on digitalisation, 96% of individuals in Iceland using internet banking in 2020, the highest in Europe (*source: Eurostat*).

Personal Banking

Personal Banking offers a full range of financial services for individuals and households, such as lending, savings and payments. Iceland has a technologically advanced population, with 99% of Icelanders using the internet, leading to the rapid adoption of digital solutions. The Icelandic personal banking market has been stable after the financial crisis of 2008, and achieved further growth as the Icelandic economy stabilised. Several factors have contributed, and are expected to continue to contribute, to an increasing demand for personal financing, including: (i) the increasing, relatively young population; (ii) high levels of education; (iii) high GDP; (iv) low debt levels; and (v) low unemployment rates. The personal mortgage market in particular has seen greater demand than ever following the fall of policy rates set by the Central Bank of Iceland to a record low in 2020, whilst the demand for digital services and products continues to increase.

As the demand for mortgages has increased, so has total lending to households. In 2020, the market saw a spike of 24.6% in total lending to households, with mortgages leading the way.

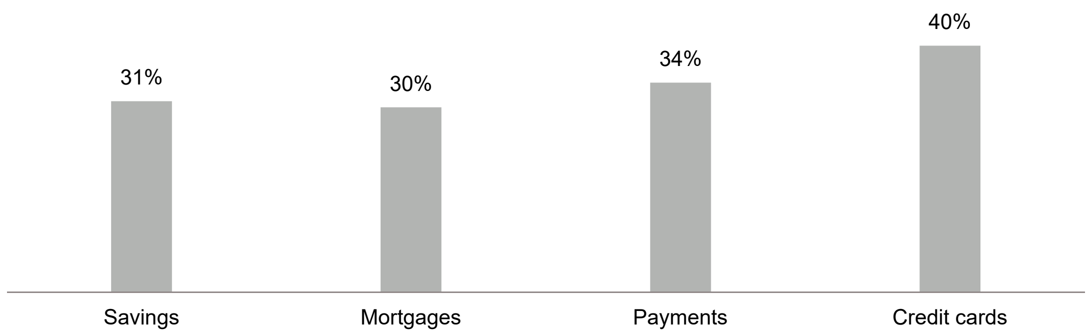
The graph below illustrates the total lending from banks to households *(source: Central Bank of Iceland*).



The Bank's main competitors in the personal banking market are Arion Bank and Landsbankinn, with the Bank's market share of individual customers amounting to 31% as at 31 December 2020 (*source: Gallup*). As a result of the 2008 financial crisis, savings banks, which in any event had a smaller share of the banking system than the commercial banks, have largely disappeared, meaning that there are limited opportunities for consolidation in the market. There are some smaller savings banks which do continue to operate.

Whilst there are currently no physical foreign banks present in the Icelandic retail banking market, over the course of the past few years, online entities have begun to emerge, acting as disruptors challenging the future market landscape.

The graph below illustrates the Bank's market share by product as at 31 December 2020 (*source: Gallup surveys*).



Savings/deposits

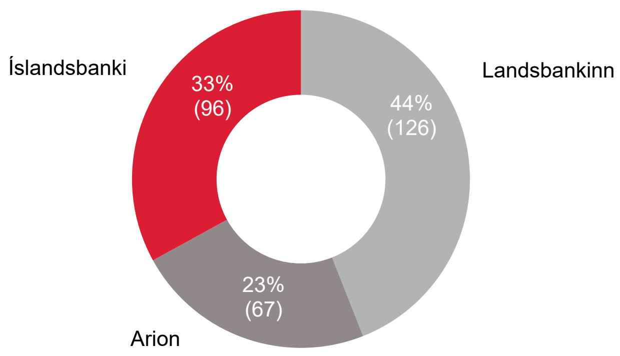
The loan-to-deposit ratio for households and non-financial corporations was 183% as at 31 December 2020, compared to 186% as at 31 December 2019. The ratio is expected to remain in this range.

The total deposits of deposit-taking institutions amounted to ISK 2,267 billion as at 31 December 2020, as compared to ISK 2,009 billion as at 31 December 2019. Deposits from households has been steadily increasing despite increased unemployment related to COVID-19 and historically low interest rates.

Mortgage loan market

Despite the steadily rising price of real estate in Iceland since 1994 (with the exception of the financial crisis in 2008), the general trend remains the same, and homeownership is notably high. The Bank's main competitors in the mortgage loan market are again Arion Bank and Landsbankinn, although various pension funds have now entered into and indeed impacted the market, offering better rates and higher LTV than had previously been available.

The graph below illustrates the increase in mortgage lending of the three largest banks in Iceland, totalling ISK 289 billion as at 31 December 2020, and the share of each bank in the overall increase in balance (*source: annual reports of the Bank, Arion Bank, Landsbankinn*).



Since 2017, the Bank's total market share of mortgages has steadily increased from 18% to 19.25% (*source: Central Bank of Iceland*), and the Bank's customer base has enjoyed a corresponding increase of 12,000 to 13,500; the Bank now finances more households in Iceland than ever before.

The Bank entered the mortgage space in 2004. Prior to that, the Bank did not have a strong footprint in the housing lending market, which had been dominated by the Icelandic Housing Financing Fund (now the Housing and Construction Authority); by way of comparison, against its current market share of 9.7%, in 2004, the market share of the Housing Financing Fund was approximately 71.5%. The Housing and Construction Authority changed its role as a leading provider of mortgages following the financial crisis in 2008, and its role today is to sustain a stable housing market and to ensure that there is a professional housing industry.

In 2016, the Icelandic pension funds increased their emphasis on the housing lending market. The Icelandic pension funds' mortgage exposure increased from ISK 172 billion at the end of 2016 to ISK 519 billion at the end of 2019. The proportion of non-indexes loans grew from 8.5% to 21.5% over the same period. In 2019 and 2020, many of the Icelandic pension funds made amendments to their product offering, implementing stricter criteria for applicants. The funds required a longer history of pension payments into the funds from applicants and offered lower leverage rates. Historically the pension fund could offer better rates for CPI-linked loans than the banks. However, whilst at the beginning of 2019, approximately 78% of all mortgages in Iceland were CPI-linked, this dropped to approximately 58% at end of 2020. In 2020, the pension funds' mortgage exposure decreased by ISK 10.9 billion.

Due to lower interest rates, the lower cost of refinancing and customers' shift away from pensions funds, the refinancing of mortgages increased in 2020, and the Bank's mortgage market share increased over this period. The Personal Banking division's strongest competition is in the mortgage loans market, where its main competitors are Arion Bank and Landsbankinn.

Business Banking

Business Banking provides comprehensive banking services and versatile banking products on service platforms, to SMEs such as lending, savings products and payment solutions offered through branches, via online banking and app. The Business Banking sector is dominated by the Bank, Arion Bank and Landsbankinn.

SMEs are the backbone of the Icelandic economy, with SMEs ensuring economic and social stability, and are important as regards to investment, innovation, and inventions. Their numbers have risen in all regions throughout Iceland over an eight-year period from 2008 to 2016 (*source: Reykjavík Economics*), and their balance sheets have become stronger. Competition is on the rise, and new financing options based on digital solutions have entered the market. There are clear signs of reduced leverage and increased profitability, suggesting strongly that companies are better prepared to face small or large economic fluctuations in the future. 99% of corporates in Iceland have fewer than 50 employees, and 97% of Icelandic corporates have turnover less than ISK 500 million (*source: Reykjavík Economics*). Over recent years, SMEs' debt ratios have decreased, and equity has increased (*source: Reykjavík Economics, Íslandsbanki Research*).

The Bank has been a market leader within the SME market, with 38% market share in 2021 (*source: Gallup*).

Throughout the last 10 years, according to Gallup surveys, the Bank has scored the highest in customer satisfaction within the market with a net promoter score ranging from -30 in 2010 to +12 in 2017, standing at -4 in 2020. In 2020, the Bank was considered the first choice for new SME businesses, with 37% of new businesses choosing the Bank as their first choice when looking at which financial institution to do business with (*source: Gallup*).

75% of SMEs in Iceland are located in the greater capital area in which the Bank is the market leader with a 45% market share in 2021 (*source: Gallup*).

Asset-based financing market

In the leasing market, the Bank, along with its brand Ergo, is a market leader in sectors such as the financing of rental cars and the financing of registered equipment and machineries.

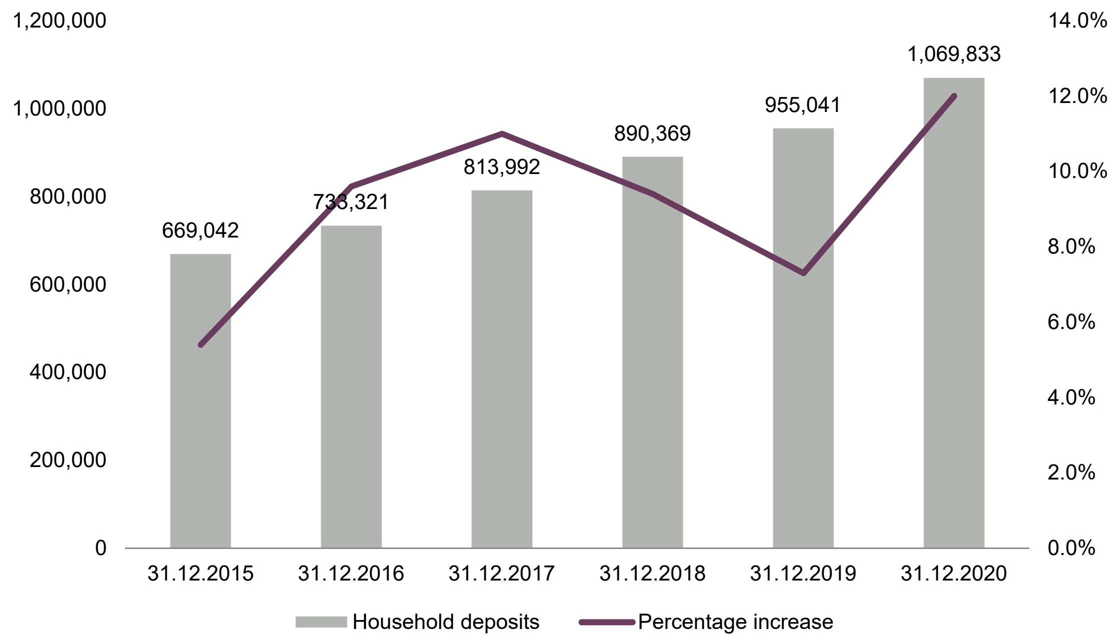
Within the leasing market, there are four dominant players: Arion Bank, Ergo, Landsbankinn and Lykill (now part of Kvika). The individual part of the market has seen great competition in prices, funding cost and loan to value ratios.

Market share total for each competitor is not directly measurable from public information provided by competitors. In Iceland 9,369 new passenger cars were sold in 2020 compared to 11,728 in 2019 and 17,976 in 2018.

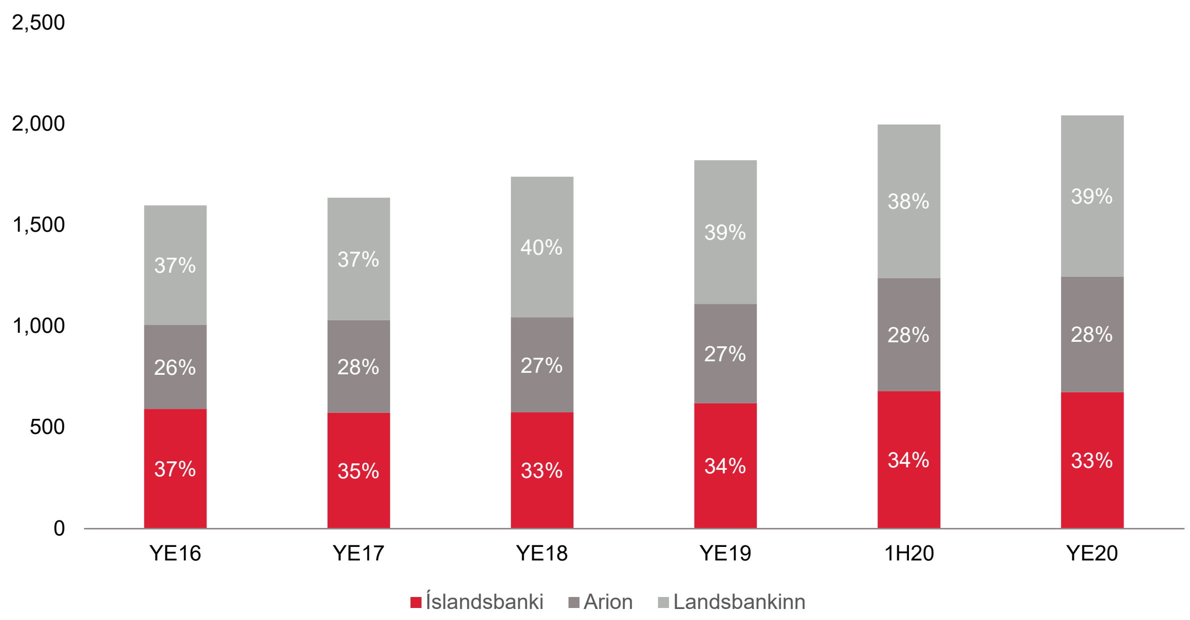
Iceland ranks second in the world for the proportion of new electric cars sold (*source: World Economic Forum*). 58% of new car sales in 2020 were fully electric, plug-in hybrid or hybrid cars (*source: Association of Icelandic Car Owners*). Fully electric cars and plug-in hybrid amounted for 45% of sales of new cars in 2020 (*source: World Economic Forum*).

Deposits and loans in Iceland

The graph below illustrates the increase of deposits (in ISK millions) by households since year-end 2015 (*source: Central Bank of Iceland*).

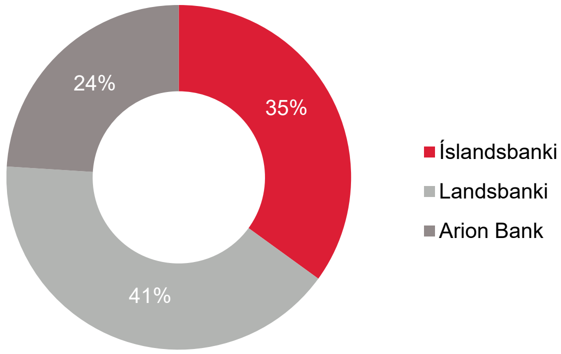


The graph below illustrates the total deposits (in ISK billions) of the three largest banks in Iceland and the share of each in the overall balance for the dates indicated (*source: annual reports of the Bank, Arion Bank, Landsbankinn*).



The decrease of the Bank's market share from 34% of deposits at the end of 2019 to 33% at the end of 2020 is primarily attributable to a large increase that Arion Bank has experienced in the deposit category for sovereigns, central banks and public sector enterprises over the period.

The breakdown of corporate loans in 2020 amongst the Bank, Arion Bank and Landsbankinn is set out below (*source: Annual statements of the Bank, Arion Bank and Landsbankinn*).



Corporate & Investment Banking

The Corporate & Investment Banking division provides comprehensive universal financial and investment banking services to large companies, municipalities, institutional investors, and high net worth individuals. The product and service offering are a comprehensive range of financial and investment banking services, including lending, securities and currency brokerage, corporate advisory services, private banking services and sales of hedging instruments.

The domestic large corporate banking market is serviced by the Bank, Arion Bank and Landsbankinn as well as foreign banks and institutions. The domestic division, representing roughly two-thirds of the market, is dominated by the Bank and its two above-noted competitors. It is estimated that the remaining one-third of the market is held by foreign banks and institutions, as they have historically been strong lenders to the largest Icelandic listed companies with international operations as well as the large infrastructure, utilities, transportation and seafood companies.

The corporate banking market has been very competitive in recent years, although the trends have shifted somewhat due to factors such as a changing interest rate environment and the changing risk and lending appetite of the Bank's main competitors. Further, a recent change in the behaviour of institutional investors, mainly due to the lower ISK interest rate environment, has led to a stronger demand for corporate bond issuances, primarily in CPI linked ISK, which has put downward pressure on pricing.

The competitive environment of corporate banking has put pressure on margins historically, highlighting the importance of relying on experienced employees to combine lending income with fee and commission income for both corporate banking as well as other divisions within the Corporate & Investment Banking division.

The exchange rate of the Icelandic Króna is determined in the interbank foreign exchange market. In addition to the Central Bank of Iceland, three financial institutions are authorised to participate in the foreign exchange market and are designated as market makers, the Bank, Arion Bank and Landsbankinn. The foreign exchange market is mainly governed by the Central Bank of Iceland's Rules on the Foreign Exchange Market, No. 600/2020.

The price of the Icelandic Króna versus the euro is determined in the foreign exchange market, where market makers are committed to submit bid and ask quotes. The quotes are published in the Bloomberg information system. The Central Bank of Iceland publishes the official exchange rate of the Icelandic Króna against foreign currencies each business day. The exchange rate listing provides a snapshot of the position in the market at the time the entry is made and is intended solely for information purposes.

The trading volume of equities in 2020 and 2019 were 43.9% and 56.9%, respectively, calculated as market turnover for each year over the average market cap in each period. This ratio is sometimes identified as the turnover ratio. The annual turnover ratio of listed bonds in 2020 and 2019 was 65.2% and 51.8%, respectively. Bonds that had no trading volume in the secondary market were excluded, and the dirty price at year end (including accrued interest based on the coupon rate) was used for bonds. The turnover ratio for both asset classes combined in 2020 and 2019 was 57.8% and 51.8%, respectively. The total market capitalisation of the domestic equity market amounted to 51.8% of the estimated 2020 GDP at year end 2020.

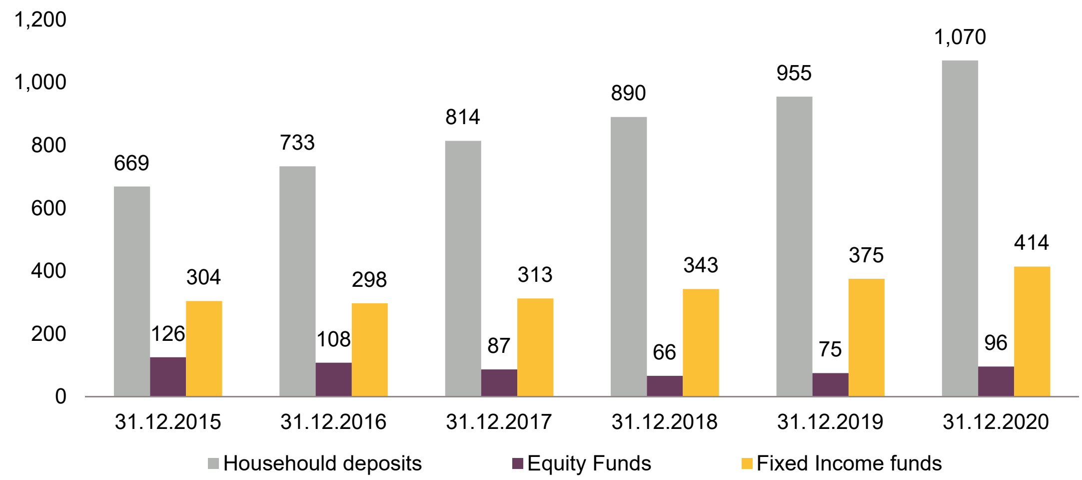
Asset Management

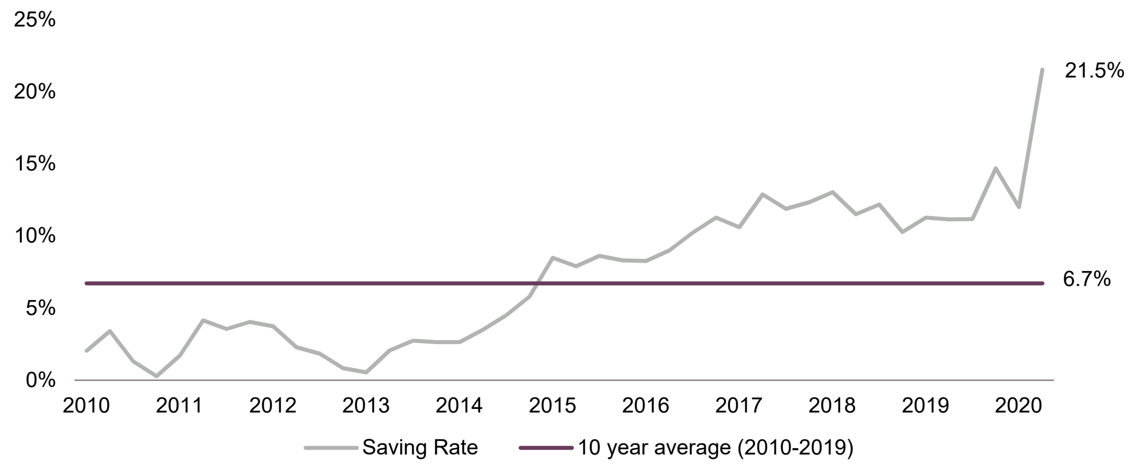
The savings market in Iceland has historically been largely dominated and driven by pension funds. Since the financial crisis in 2008, the market has seen continued growth, greater international investment and broadening of product offerings. Assets held by pension funds were ISK 5,818 billion as of 28 February 2021, almost 200% of GDP (*source: Central Bank of Iceland, Statistics Iceland*). Total assets under management by Icelandic fund management companies, pension funds and pension savings depositaries reached approximately ISK 6,950 billion by year end 2020, thereof bonds 43% and 28% in equities (*source: Central Bank of Iceland*).

The table below sets out selected statistical information on pension fund assets and deposits in Iceland (*source: Statistics Iceland and Central Bank of Iceland*).

	As at 31 December										
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
	(ISK in millions, except population)										
Population in Iceland	318,470	319,560	321,890	325,620	329,040	332,750	338,450	348,580	357,050	364,260	368,590
Pension funds assets	1,988,850	2,169,145	2,438,979	2,695,575	2,935,072	3,284,331	3,539,967	3,944,339	4,244,671	4,974,933	5,715,729
Pension fund deposits	158,644	154,421	165,265	161,525	129,275	151,726	116,608	150,812	142,872	151,492	164,910
Pension fund assets per capita	6.2	6.8	7.6	8.3	8.9	9.9	10.5	11.3	11.9	13.7	15.5
GDP per capita	5.3	5.5	5.8	6.1	6.4	7.0	7.5	7.7	8.1	8.4	8.0

The graphs below set out the household savings market (in ISK billions) and savings rate (in percentage points) in Iceland for the periods indicated (*source: Central Bank of Iceland*).



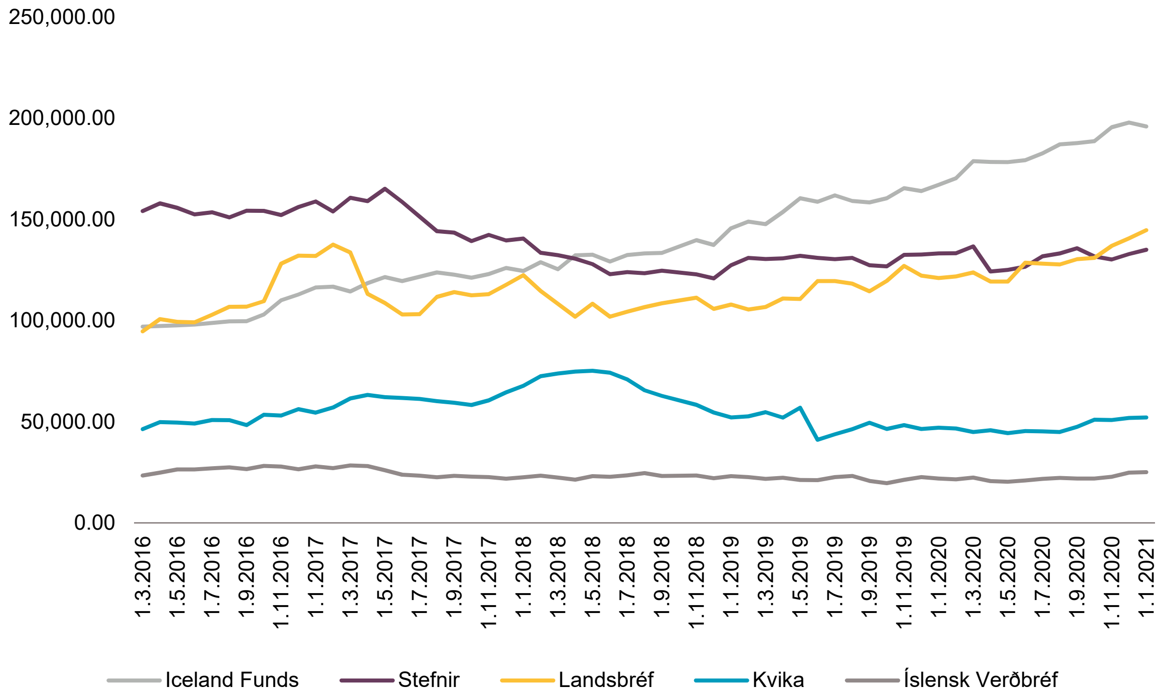


Íslandssjóðir, or Iceland Funds, is the largest and oldest mutual fund manager in Iceland, with ISK 200 billion in domestic funds and a market share of 34% as at 31 December 2020 compared to 23% as at 31 December

2016. Total assets under management have grown steadily and now total ISK 349 billion (as at 31 December 2020), consisting of discretionary asset management (ISK 135 billion), alternative funds (ISK 14 billion) and domestic mutual funds (ISK 200 billion).

Iceland Funds has become the largest player in the individual market and its biggest competitors are Landsbréf and Stefnir, along with smaller fund management companies such as Kvika eignastýring, Akta and Íslensk Verðbréf.

The graph below sets out the volumes of assets under management (in ISK millions) in the Icelandic domestic fund market as of the dates indicated (*source: keldan.is*).



The Bank is the only bank in Iceland that has partnered with well-known and respected fund and asset management companies such as Storebrand and Vanguard.

Card and Electronic Payments

Around the beginning of the 21st century, every Icelandic citizen carried, on average, more than 2.5 plastic cards in their wallet. More recently, there has been a shift away from the use of such physical cards and towards the use of mobile apps and wearable payment methods. Indeed, the most popular payment method in Iceland is now Apple Pay, whilst payments made using Android phones and wearables like Garmin Pay and Fitbit Pay are also starting to increase in volume. In 2020, contactless payments increased by 50% at the Bank and the Bank believes this trend will continue.

The Bank is also a market leader within credit cards, with a market share estimated to be around 40% as at 31 December 2020, and the Bank's debit card market share is around 32% (*source: Central Bank of Iceland total market data*).

Competition

The Icelandic banking sector, in particular the three main Icelandic banks, have a high overall market share for both corporate loans, due to the relatively small corporate bond market in Iceland, and mortgages, where the Housing and Construction Authority is reducing its participation in the mortgage market.

The Bank faces competition from the other large Icelandic banks, Kvika, four small savings banks in rural areas, pension funds and smaller specialised institutions, as well as foreign banks without local operations in Iceland. The competition from foreign banks and lending institutions is most in the market for large companies. Further, the investment banking and wealth management markets are highly competitive with many active market participants. The Bank expects to compete on the basis of a number of factors, including transaction execution, its products and services, its ability to innovate, reputation, and price.

The Bank believes that it compares favourably to its main competitors, Arion Bank and Landsbankinn, with the strongest customer satisfaction (*source: Gallup surveys 2020 and 2021*) and high digital adoption among customers, with 90,000 users of the Bank's app in 2020, compared to 86,000 users of Arion Bank's app and 70,000 users for Landsbankinn's app (*source: Arion Bank and Landsbankinn public information*). In addition, the Bank has the most efficient branch network, with 12 branches compared to 15 branches for Arion Bank and 34 branches for Landsbankinn, and the highest personal banking loan book per branch, of ISK 35 billion for the Bank as at 31 December 2020, compared to ISK 29 billion for Arion Bank and ISK 14 billion for Landsbankinn as at the same date. The Bank has also prioritised a focus on core income, comprising net interest income and net fee and commission income, which accounted for 75% and 24%, respectively, of the Bank's income in 2020 (excluding negative other income of ISK 743 million in 2020), in comparison to 61% and 23%, respectively, for Arion Bank, and 76% and 15%, respectively, for Landsbankinn, in each case over the same period.

Details of the main competitors of the Bank's divisions and subsidiaries in the provision of its various products and services are set forth below.

Personal Banking

As at 31 December 2020, according to a Gallup survey regarding primary banks, the Personal Banking division held a 31% market share for individual customers. The Bank is also a market leader within credit cards, with a 40% market share as at 31 December 2020 (*source: Central Bank of Iceland total market data*).

The main competitors of the Personal Banking division in the deposits market are Arion Bank, Landsbankinn and Kvika. Savings banks have largely disappeared since the financial crisis in 2008, although some smaller savings banks continue to operate in certain regions. The Personal Banking division's strongest competition is in the mortgage loan market, in which the Personal Banking division's main competitors are Arion Bank and Landsbankinn.

There have been new market entrants that have disrupted the market with simplified product offerings and digital and technology development of external players could lead to customer exit.

Business Banking

As of March 2021, according to a Gallup survey regarding primary banks, the Business Banking division held a 38% market share.

The main competitors of the Business Banking division in the SME market are Arion Bank, Landsbankinn and Kvika. The Business Banking division is the only division among these banks focusing solely on SMEs in line with the Bank's customer centric strategy. Landsbankinn has a corporate division and Arion Bank has a combined retail division for individuals and SMEs. Access to digital solutions has increased significantly in the recent years among all competitors for SMEs. The asset-based financing unit of the Bank, Ergo, operates within Business Banking.

Corporate & Investment Banking

At the end of 2020, the Corporate & Investment Banking division held a 35% market share according to a Gallup survey. The Bank was also the leader in securities trading volume in the Icelandic market in 2020, with a market share of 18.7% (*source: Nasdaq Iceland*).

The Corporate & Investment Banking division's main competitors in the corporate banking market are Arion Bank and Landsbankinn, with several other participants including pension funds (indirectly through investment in asset-backed securities), public funds (e.g., the Housing and Construction Authority), foreign lenders and smaller financial institutions (e.g., Kvika). Pension funds have increased margin pressure since 2013, and they mainly provide funding through investment in bonds and asset-backed debt instruments. Foreign banks also provide the Bank competition as they seek to enter the Icelandic corporate banking market. The investment banking market is characterised by price competition and competition in transaction terms, which requires constant focus on maintaining healthy margins.

Íslandssjóðir hf. (Iceland Funds)

The asset management industry sector is highly competitive and has moderate barriers to entry. Competition in the asset management industry sector is largely based on investment performance, the level of fees, the quality and diversity of products and services, name recognition and reputation, the effectiveness of distribution channels and the ability to develop new investment strategies and products to meet the changing needs of investors, particularly in this digital age.

Iceland Funds is a market leader in mutual funds in Iceland, as its current market share in mutual funds was 34% as at 28 February 2021 based on assets under management of Icelandic fund management companies. This has grown steadily from 23% as at 31 December 2016.

BUSINESS OVERVIEW

Overview

The Bank is a customer-centric universal bank, headquartered in Iceland. Its primary market is Iceland.

The Bank is licensed as a commercial bank in Iceland in accordance with item 1 of Article 4(1) of the Financial Undertakings Act and offers comprehensive services to the retail and corporate sectors. The Bank is one of Iceland's three main banks and maintains a strong market share across the spectrum of banking services in the country. According to surveys by Gallup in Iceland in December 2020, the Bank had approximately 31% of the market share in Personal Banking, 35% of the market share in Business Banking and 35% of the market share of Corporate & Investment Banking. The Bank seeks to move Iceland forward by empowering its customers to succeed and prioritise sustainability as an integral driver of strategy and value creation.

The Bank's core values are passion, professionalism and collaboration.

For the years ended 31 December 2020, 2019 and 2018, respectively, the Bank's net interest income was ISK 33,371 million, ISK 32,822 million and ISK 31,937 million, its net fee and commission income was ISK 10,525 million, ISK 10,899 million and ISK 12,227 million, its operating income was ISK 43,153 million, ISK 45,165 million and ISK 44,987 million and its profit for the year was ISK 6,755 million, ISK 8,454 million and ISK 10,645 million. As at 31 March 2021, the Bank's total assets were ISK 1,385,235 million.

History

The Bank traces its roots back to 1875. The original Íslandsbanki hf. was founded as the first privately-owned bank in Iceland in 1905. Útvegsbanki Íslands took over Íslandsbanki's operations in 1930 and in 1990, Útvegsbanki Íslands, Alþýðubanki Íslands, Iðnaðarbanki Íslands and Verslunarbanki Íslands merged into Íslandsbanki hf. In 2000, the Bank merged with The Icelandic Investment Bank (FBA), which was created through the merger of three state-owned credit funds, forming Íslandsbanki-FBA hf. As a result of the merger, the Bank further solidified its connections with the corporate sector, particularly in the seafood industry. In the years 2000 to 2007, the Bank expanded its business beyond Iceland by first lending to seafood enterprises in northern Europe and North America, and later through strategic acquisitions in the Nordic countries. In March 2006, the Bank was rebranded as Glitnir banki hf.

As a result of the crisis of the Icelandic banking system in 2008 and pursuant to the Act on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances etc. No. 125/2008 (usually referred to as the Emergency Act), in October 2008, there was a restructuring of the Bank. As part of the restructuring, the Bank, as a new entity named New Glitnir bank hf., assumed the domestic assets and liabilities of Glitnir bank hf. while the remainder of Glitnir bank hf.'s assets, which were mostly foreign assets, were left within Glitnir bank hf. under the supervision of a resolution committee, which was appointed to maximise the recovery value of those assets for the benefit of its creditors. The Bank reverted to its previous brand name of Íslandsbanki hf. on 20 February 2009. The Bank is one of the few European banks that has not had to raise additional equity since the global financial crisis.

On 13 September 2009, Glitnir bank hf., on behalf of its creditors, and the Icelandic state reached an agreement on the settlement of the assets and liabilities the Bank had assumed as part of the restructuring. Under the agreement, ISB Holding ehf., a holding company wholly owned by GLB Holding ehf. (a subsidiary of Glitnir banki hf.) acquired a 95% stake in the Bank. This 95% stake was then transferred to the Icelandic state, effective following approval by the ICA on 11 March 2016.

In June 2011, the Bank announced that it had successfully won a public bid for the entire share capital of Byr hf., a local bank in Iceland. Byr hf. focused mainly on retail banking and was built on the foundation of an older savings bank, which became insolvent in April 2010. The shares were acquired from Byr hf.'s winding up committee and the Icelandic state. The acquisition price was ISK 6.6 billion. The acquisition agreement was executed on 29 November 2011, and the acquisition was completed in the first quarter of 2012.

In March 2011, the Bank acquired all shares of the credit card company, Kreditkort hf. and on 27 March 2012, Kreditkort hf. was merged into the Bank. In 2020 the Bank sold its entire stake in Borgun hf. For additional information on the sale, see "*Legal Considerations and Supplementary Information – Material Contracts*".

From 2013 to 2016, the Bank introduced a relationship banking model focused on efficiency and minimising complexity for customers. Between 2017 and 2019, the Bank underwent a digital transformation. The Bank successfully replaced its core banking system, including an effective migration of an old legacy system to a global standardised core banking system (SOPRA) for payments and deposits in 2018 and the Board approved an open banking strategy in 2018. Since 2019, the Bank has had a commitment to empowering customers to succeed and has played a more active role in seeking to shape and progress society, such as through its green initiatives, described in more detail below.

Strengths

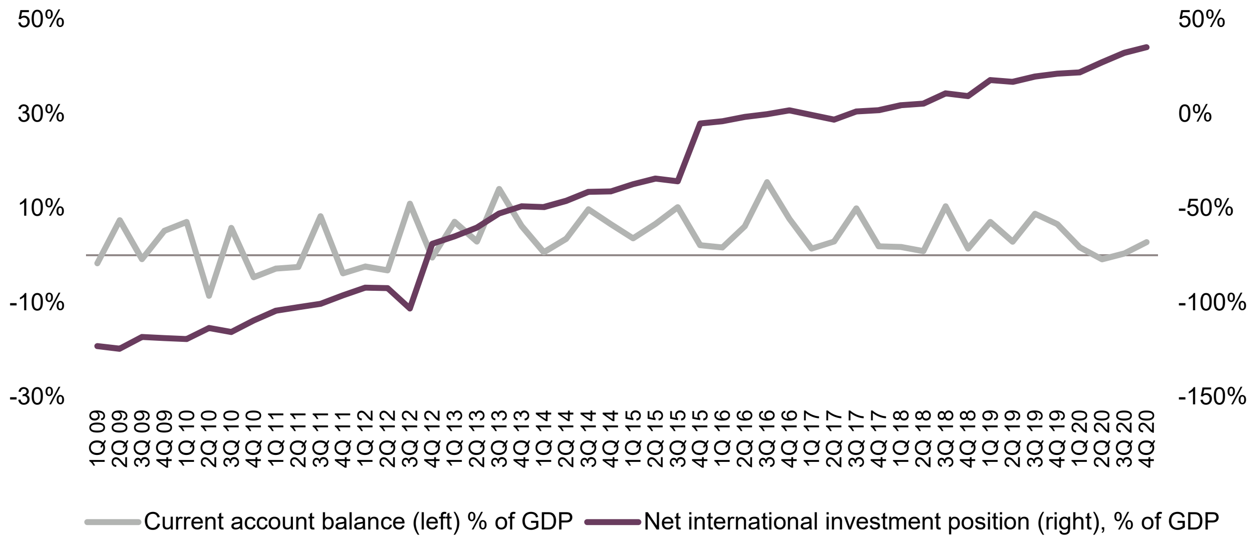
Attractive banking market with outlook for strong growth and rising rates, with a proven track record of fast recovery and a positive interest rate environment

Iceland has a GDP per capita of approximately U.S.$60,000 in 2020 (*source: IMF*), one of the highest in the world. Real GDP in Iceland declined by 6.6% in 2020, due to COVID-19, but increased in each of 2018 and 2019 by 4.7% and 2.6%, respectively (*source: Statistics Iceland*), while its unemployment rate has on average measured 4.7% in the period 2010-2019, significantly below many other countries, including Sweden, Ireland and the average in the Eurozone (*source: Statistics Iceland, OECD*). The unemployment rate for 2020 increased to 7.9%, largely due to the impact from COVID-19, from 3.5% in 2019 and 2.7% in 2018. Government gross debt as a percentage of GDP has decreased since 2011; however, the IMF projects that, due to the impact of COVID-19, this will increase from 79.9% in 2020 to 88.7% in 2023 (*source: Statistics Iceland, IMF*). Iceland also has a robust current account surplus which stood at 1.1% of GDP in 2020 and a positive net international investment position of 35% GDP as at and for the year ended 31 December 2020 (*source: The Central Bank of Iceland*). While the above figures demonstrate the negative effect that COVID-19 has had on the Icelandic economy, the Bank believes the Icelandic economy is likely to return to the growth previously experienced as a result of several factors, including lower real exchange rates and robust external balance. Iceland's moderate leverage across the economy also increases the economy's resilience to shocks to the system and the rates environment remains highly attractive in comparison to other countries. Furthermore, Iceland's strong economic base is supported by a modern legislative framework and public institutions.

Furthermore, Iceland benefits from a diversified economy supported by four export pillars: tourism (i.e. as a source of foreign income), seafood, energy and other industrial goods and services. In 2020, exports contributed approximately 34% to Iceland's GDP. Iceland benefited from an accelerated growth in tourism; however, the number of tourists declined by 14% in 2019 and 76% in 2020 as the pandemic shut down the sector for a significant portion of the year (*source: Statistics Iceland, Isavia*). This strong economic backdrop, up until the arrival of COVID-19, has supported Iceland's growing and stable banking sector. The sector is centred around the Bank, Arion Bank (which is publicly owned) and Landsbankinn (owned by the Icelandic state), with the three banks having a combined market share of 52% of loans to households, 80% of loans to corporates and 98% of deposits from customers as at 31 December 2020 (*source: Ministry of Finance and Economic Affairs and the Bank, Arion Bank and Landsbankinn annual reports*).

Iceland also has highly attractive interest rates compared with the rest of Europe and the United States, with the OECD's short-term interest rate forecast for three-month money market rates for Iceland increasing from 1.3% in the first quarter of 2021 to 2.2% by the fourth quarter of 2022. In this respect, the Icelandic government base rate curves well above negative territory, while banks in other countries in Europe are struggling with the effects of negative rates for a longer period of time. The Bank is well positioned to benefit of steepening of the yield curve due to significant short-term deposit funding used to fund a long-term asset base.

Finally, the Icelandic Króna is a currency underpinned by a solid net external position. The graph below sets out, for the period from 2009 to 2020, Iceland's relatively stable current account balances (as a proportion of Icelandic GDP) and increasing net international investment positions (as a proportion of Icelandic GDP), when taking into account adjustments for the effects of failed financial institutions in the period from 2009 to 2015 (*Source: Central Bank of Iceland*).



The Bank considers itself a digital champion with a solid technical foundation and an efficient omni-channel strategy

The Bank has a solid technical foundation, supported by next generation product systems and a product-centric delivery model, creating a modern, innovative and cost-efficient bank. The Bank is digitally connected with its customers and partners helping them to experience frictionless banking services, based on their needs. In 2018, the Bank successfully migrated to a global standardised core banking system for payments and deposits through SOPRA. The Bank's digital partnerships with Meniga, Payday and boost.ai have been key to the development of the Bank's scalable and flexible platform. Since 2018, the number of the Bank's digital solutions have increased by 400%. By the end of 2021, the Bank expects to have completed the full replacement of its loan systems.

The Bank's digital platform, combined with its relatively lean branch network, supports demand for increased efficiency and customer willingness to use digital channels. In 2020:

- the Bank had over 31 million digital customer interactions, with 50,000 active customers in online banking and 90,000 active customers in the app;
- 99% of the Bank's customer interactions with individuals occurred through digital channels, including the online bank, app, contact centre and chatbot, representing a compound annual growth rate of 20% over the period from 2017 to 2020;
- the Bank experienced a 47% increase in customer onboarding through its digital onboarding platform;
- 99% of all of the Bank's credit evaluations for individuals were processed automatically; and
- 71% of the Bank's individual customers were digital only.

In turn, this has allowed for the reduction in branch numbers to 12 branches, as compared to 34 for Landsbankinn and 15 for Arion Bank. The Bank believes that customer satisfaction and market share have not been negatively impacted by the changes in the branch network. It also maintains a presence in larger municipalities across Iceland. In addition, this operating efficiency has also been reflected in the Bank's operating expenses as a proportion of assets, which, after adjusting for the sale of Borgun and excluding the Bank Levy, decreased from 2.3% for 2018 to 1.8% for 2020.

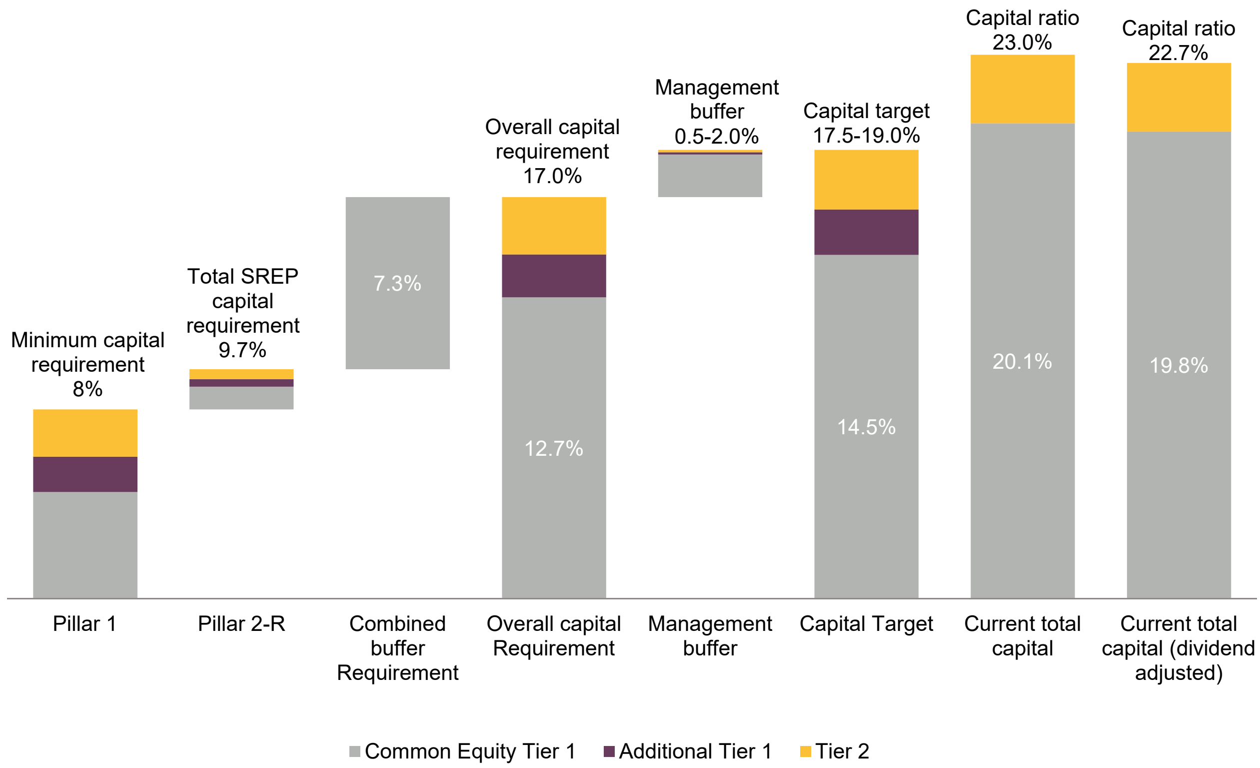
The Bank has a clean and robust balance sheet supported by strong loan and risk culture

The Bank believes that it has a clean and robust balance sheet, no legacy exposures and up-to-date core banking systems. As at 31 December 2020, its CET1 ratio and capital adequacy ratios calculated in accordance with the definition set forth in the CRR were at 20.1% and 23.0%, respectively. Furthermore, the risk-weighted assets density of the Bank remained stable at conservatively high levels, as compared to banks in Norway, Denmark, Sweden, and Finland. The Bank's risk-weighted assets as a percentage of total assets amounted to 69%, 74% and 75%, as at 31 December 2020, 2019 and 2018, respectively.

The Bank has a strong diversified loan portfolio with mortgages representing the largest loan category at 37% and no other sector reflecting more than 16% of the loan portfolio. The Bank's diversified portfolio consists of loans to individual customers comprising 43.4% and loans to corporate customers comprising 56.6% as at 31 December 2020. As at 31 December 2020, 2019 and 2018, non-performing loans based on gross carrying amount represented 2.9%, 3.0% and 2.0%, respectively, and the Group's impairment allowance on its customer loan portfolio amounted to 1.7% (1.1% as at 31 December 2019 and 0.9% as at 31 December 2018) of the total gross amount of the portfolio. The provisions for losses as a percentage of gross impaired loans (coverage ratio) decreased from 21.3% in 2018 to 20.9% as at 31 December 2019 and increased to 25.3% as at 31 December 2020. The Bank also benefits from a diversified funding structure that is predominantly based on deposits and complemented by wholesale funding in the form of various debt securities. The Bank has issuances of bonds under its covered bond facilities in the Icelandic market. As at 31 December 2020, deposits from customers comprised 54%, shareholders' equity comprised 14%, senior unsecured bonds 16%, bonds issued under covered bond facilities comprised 13% and other liabilities comprised 2% of the Bank's funding sources. The Bank has a robust liquidity position with limited near term refinancing needs, with liquid assets equal to ISK 285 billion (21% of total assets) and its LCR equal to 196% as at 31 December 2020. The Bank is currently rated BBB/A-2 with a stable outlook by S&P Global.

As a result of these factors, the Bank has significant dividend capacity in line with its medium-term target to reduce its CET1 ratio to approximately 16% from 20.1% as at 31 December 2020. However, the Bank's ability to distribute such dividends depends on several factors, including (but not limited to) management of the Bank's foreign exchange imbalances, its capital optimisation strategy (including the issuance of AT1 capital) and regulatory consents.

The bridge below presents the regulatory capital requirements and capital ratio as at 31 December 2020.



The Bank has an ingrained culture of service and risk mindfulness

The Bank's experienced management team is supported by a highly skilled and engaged workforce. High employee satisfaction and an ingrained culture of service and risk mindfulness are key assets of the Bank. The

Bank has had consistently high Net Promoter Score over the previous 10 years with large corporate customers. The Bank has a strong risk culture, which is reflected in lower capital requirements when compared to its peers. As at 31 December 2020, the Bank's overall capital requirement equalled 17.0%, compared to 18.4% for Arion Bank and 18.8% for Landsbankinn.

The Bank is a leading relationship bank in Iceland with a differentiated and innovative approach

The Bank is a customer-centric universal bank focused on Iceland, with a state-of-the-art banking platform, providing its customers with a diverse range of financial products and services, through its three key business divisions, Personal Banking, Business Banking and Corporate & Investment Banking, as well as its strategic subsidiaries, in particular Iceland Funds. The Bank aims to respond to its customers' ever-growing needs and to provide innovative and helpful solutions through the Bank's services and products across its industries.

Personal Banking

The Personal Banking division offers a full range of financial services for individuals and households, such as lending, savings and payments, with a particular focus on digital and self-service solutions. As at 31 December 2020, the Personal Banking division had a market share of individual customers of 32% (*source: Gallup survey*). The operating income of the Personal Banking division has remained steady from ISK 14,511 million in 2018 to ISK 15,159 million in 2019 and ISK 14,103 million in 2020.

The key strengths of the Personal Banking division are:

- Strong market position with a stable financial performance. The Personal Banking division of the Bank is top ranked and is market leading, financing more households nationwide with an overall market share of 31% in Iceland as at 31 December 2020 (*Source: Gallup survey*).
- Demonstrated customer-centric approach with high customer satisfaction and growing customer base. The Bank has seen faster digital activity growth than other banks in Nordic countries with over 31 million digital customer interactions per year. The Bank was the first bank in Iceland to launch an AI chatbot, which provides answers for over 90% of all customer questions.
- Growth model driven by optimised product offering and high-quality loan book. The Bank's simplified customer journey has led to the Bank's increased market share in mortgage lending across the Icelandic banks at 29.7% in 2020 (*source: Central Bank of Iceland*) and the number of mortgage loans issued growing from 2,092 in 2019 to 4,598 in 2020.
- Strategic digital journey contributing to ROE as well as improved customer experience. Sales via digital channels are consistently increasing, while fewer employees of the Bank have generated more revenue. The Bank, through its exclusive contract with MasterCard, has also become a market leader in credit cards, with 40% of the market share, according to a 2020 Gallup survey. The Bank has also provided digital offerings for its private pension plans to its customers.
- Strong financial performance with consistent track record and attractive outlook. The mortgage margins of the Bank have risen by 44% since 2018, while the total lending portfolio grew 28% in 2020. Deposits have been growing steadily and are expected to increase by 20% over the next 5 years.
- Clear vision focused on new pillars and market trends for growth. The Personal Banking division has a proven track record of successfully implementing strategic initiatives while simultaneously being a steady low-risk contributor to the Group results.

Business Banking

The Business Banking division provides comprehensive banking services and versatile banking products to SMEs, such as lending, savings products and payment solutions. Additionally, the Bank provides asset-based financing services through its separate brand, Ergo. It generates operating income through the provision of credit products, deposits and other banking services, on which the Business Banking division earns interest income and fee and commission income. In 2020, the Business Banking division had a total market share of 35% in Iceland and 42% in the Reykjavík area (*source: Gallup survey*). The operating income of the Business Banking division has grown steadily from ISK 11,306 million in 2018 to ISK 12,553 million in 2019 and ISK 12,503 million in 2020.

The key strengths of the Business Banking division are:

- Business Banking has a robust business model and advanced service strategy. The Bank has a strong market share across different sectors operating today on 65% fewer branches than its main competitors and is considered the leader in the SME market with the highest net promoter score among its Icelandic peers (*source: Gallup survey*).

- The Bank emphasises and provides personal service, built on advanced and well-developed service strategy with productive, motivated and highly skilled staff responsible for high customer satisfaction.

- Operational efficiency through economies of scale and digital transformation. Business Banking has an efficient omni-channel offering access to banking through web, online bank, mobile app, API, chatbot, contact centre and branches. The Bank provides customers access to best-in-class technology and solutions, including electronic signatures, touchless payments, corporate on boarding through web and corporate mobile app.

- The Bank is well positioned to meet fast changing customer demand for sustainable products. The first sustainable lending product in the Bank was green financing through Ergo. Ergo was the first on the market to offer loans for electric bicycles and charging stations.

- The division has a strong credit culture with well diversified loan portfolio. Despite negative COVID-19 impact in 2020, the loan portfolio significantly exceeded GDP as SMEs continued to be an important source of investment, innovation and invention driving economic growth.

- The Business Banking division was voted the best online bank for corporates by a Gallup survey in 2020.

Corporate & Investment Banking

The Corporate & Investment Banking division provides universal financial and investment banking services to large companies, municipalities, institutional investors, and high net worth individuals. The product and service offering are a comprehensive range of financial and investment banking services, including lending, securities and currency brokerage, corporate advisory services, private banking services and sales of hedging instruments. It generates operating income by providing credit products, deposits and investment banking services to corporate customers and institutional investors as well as asset management for high net worth individuals and institutional investors. The customer facing units within the division are: Corporate Banking, Foreign Exchange Sales, Derivatives Desk, Securities Sales, Corporate Finance and Asset Management. At the end of 2020, the Corporate & Investment Banking division had a market share of 35% and was the leader in corporate finance in Iceland (*source: Gallup survey*). The operating income of the Corporate & Investment Banking division has increased from ISK 11,350 million in 2018 to ISK 12,491 million in 2019 and ISK 13,527 million in 2020.

The key strengths of the Corporate & Investment Banking division are:

- Extensive best-in-class products and services catering to a broad range of customers. The Bank is a leader in the corporate and investment banking market providing services in corporate banking, asset management, corporate finance, securities sales, derivatives and foreign exchange sales.

- It is staffed by experts with decades of financial experience. The Bank's Corporate & Investment Banking team has an average of 14 years of banking experience with the management team with 5 years of average tenure at their current post.

- Customer service is at the core of the division's culture and a focus on multi-product customers. According to a Gallup survey, 94% of the division's customers reported they were satisfied with the service of the Bank. In the last quarter of 2020, 83% of the Corporate & Investment Banking corporate customers stated they had proactive contact by the Bank in the last 90 days (*source: Gallup survey*).

- Strong and healthy loan book to drive future earnings. There has been a further margin increase on loans driven by focus on strategic pricing, low interest rates and stable market conditions as net fee and commission income grew at a steady rate. Loan portfolio is also growing in line with GDP.

- Focus on strategy and changing trends with the launch of further sustainable products following inaugural sustainable green bond. The Bank is focused on creating a sustainable banking framework and product offering for corporates and investors, including green construction loans and blue loans (loans certified for use to support the ocean, such as for sustainable fisheries).

Track record of a significant growing income from core banking operations

The Bank has been able to generate steady and varied income through its diversified business model. Net interest income increased by 4.5% between 2018 and 2020, mainly due to lower interest expenses from deposits, lower interest rate environment and growth in the loan book. Net fee and commission income decreased by 13.9% between 2018 and 2020, mainly due to clearing and settlement and increased card expenses offset by an increase in new lending and refinancing and an increase in payment processing fees.

The table below sets forth the net interest income, the net fee and commission income and the total operating income, as disclosed in the Annual Financial Statements.

	Year ended 31 December		
	2020 (ISK in millions)	2019 (ISK in millions)	2018 (ISK in millions)
Net interest income	33,371	32,822	31,937
Net fee and commission income	10,525	10,899	12,227
Total operating income	43,153	45,165	44,987

The table below sets forth the respective contributions of the Bank's products and services to fee and commission income, as disclosed in the Annual Financial Statements, for the year ended 31 December 2020.

Products and services	**Year ended 31 December 2020**
Asset management	18.8%
Investment banking and brokerage	19.7%
Payment processing	34.6%
Loans and guarantees	15.9%
Other fee and commission income	11.0%

The table below sets forth the improvement the Bank has demonstrated in key metrics over the decade from 2011 to 2020.

	As at and for the year ended 31 December		Change in Percentage (%) or Percentage Points (ppts)
	2011	2020	
Loans to customers (ISK billion)	564	1,007	79%
Loans per FTE (ISK million)	384	1,293	237%
Number of branches	21	12	(43)%
Percentage of digital sales	7%	42%	35 ppts
Net fee and commission income as a percentage of operating income	14.7%	24.4%	9.7 ppts
Loan to deposit ratio	115.6%	148.2%	32.6 ppts
CET1 ratio	19.1%	20.1%	1 ppt
Number of employees	1,470	779	(47)%

The Bank is a sustainability frontrunner in the Icelandic financial services industry with an ESG-ingrained culture

The Bank recognises that sustainability drives shareholder value and corporate longevity. The Bank's sustainability strategy and framework has resulted in an innovative product offering for its customers. Sustainable initiatives include:

- *Discounted green car financing offered by Ergo*. In 2020, almost one-third of loans for new cars were made through discounted green financing which offers customers a 0.75% discount in interest rates for the purchase of energy efficient vehicles. As at 31 December 2020, financing for 1,190 clean vehicles had been provided by Ergo, for an outstanding amount of ISK 3.4 billion.

- *Green savings*. The Green Bonds fund was introduced as a savings option for the Bank's customers in 2018 by Iceland Funds and was the first such fund in Iceland. As at 31 March 2021, 69.1% of the Green

Bonds fund's holdings were green bonds, which are bonds that finance sustainable projects with a positive impact on the environment and the community.

- *Sustainable financing for companies*. Loans to companies for projects that fit the criteria of the Sustainable Financing Framework, for example, renewable energy and green buildings. As at 31 December 2020, ISK 21.3 billion of corporate lending categorised as "sustainable" loans had been approved.

- *Discounted green mortgages*. In January 2021, the Bank started offering green mortgage loans with interest rate discount of 10 bps and cancellation of lending fees for purchasers of environment-friendly housing.

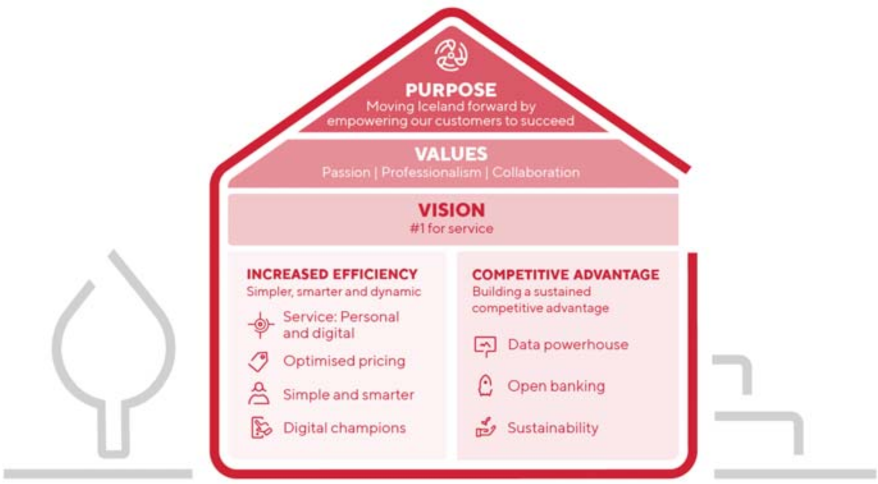
- *Net zero emissions by 2040*. In April 2021, the Bank announced target of achieving full carbon neutrality no later than 2040. The Bank's own operations have been carbon-neutral for the past two years, but with this decision, its targets will also extend to "financed emissions", which include the carbon footprint of the Bank's entire loan and asset portfolio. At the same time, the Bank commits to setting climate targets based on science-based targets and has already begun preparing a detailed plan providing for secondary objectives in line with that framework.

The Bank has received the highest ESG rating (90 out of 100 points) by Reitun, an Icelandic rating agency, and according to a Gallup survey in December 2020 of the 300 largest corporates in Iceland, twice as many mention the Bank as a sustainability leader compared to its top two competitors. In addition, the Bank's sustainability leadership has been demonstrated in its receiving the Icelandic Knowledge Award 2020 by FVH, the Association of Business and Economics Graduates in Iceland, and it being recognised for excellence in corporate governance every year since 2014 by the Centre of Corporate Governance at the University of Iceland up until 2019 and thereafter by Stjórnvísi, an Icelandic business association focused on corporate governance best practices.

In addition to these accomplishments, the Bank has also been a leader in gender equality. 43% of the Bank's Board of Directors and 43% of its Executive Committee are women, in comparison to the global average of major banks of 23% and 18%, respectively, according to an Oliver Wyman report on women in financial services from 2020. As in prior years, in 2020, the Bank received equal pay certification and was awarded professional certification under the IST 85:2012 Equal Pay Standard. Each year since 2018, the Bank has been awarded the Equality Scale by the Icelandic Association of Business Women, FKA.

Strategy

The Bank's strategy is a balanced mix of (i) building a sustained competitive advantage and (ii) increasing efficiency.



To support its strategic priorities, the Bank has defined seven strategic themes. Four themes are aimed at delivering a step change in productivity through clear focus, pricing, cost-mindfulness and new approach to digital delivery, while the three other themes are focused on building a sustained competitive advantage through leveraging data, open banking opportunities and sustainability leadership.

Some of the information contained in this section, including with respect to the strategic plan, contains forward-looking statements that involve risks and uncertainties. See "*Presentation of Financial and Other Information—Forward-Looking Statements*".

Strong execution track record of efficiency gains

The Bank has achieved continuous efficiency gains since 2011, including experiencing a significant step-change in 2019 and 2020. This has included the development of FTEs at the Bank, which has decreased at a compound annual rate of 5.0% from 2011 (1,185 FTEs) to 2020 (745 FTEs). Other key performance indicators demonstrate this trend of efficiency, as seen in the table below.

	Number of FTEs	Total assets	Assets per FTE	Assets per branch
	(As at 31 December 2020)			
Since 2011	-18%	+69%	+169%	+266%
Since 2018	-11%	+19%	+33%	+39%

In addition, the digital transformation at the Bank has enabled efficiency gains. In recent years, the way in which customers seek out banking services has changed radically. Digital solutions have become steadily more popular, while visits to branches have been on the decline. In 2017, the year before the Bank migrated to its standardised core banking system, 34% of the Bank's individual customers were digital only, compared to 71% in 2020, while the proportion of digital sales increased from 15% of total sales to 42% of total sales over the same period.

This trend is also reflected in the increase in the number of digital solutions offered by the Bank from six in 2017 to 29 in 2020 and the reduction in branch visits from 784,000 in 2017 to 305,000 in 2020. There was record high customer usage of digital self-service solutions and online sales in 2020 for the Bank. COVID-19 ushered in even faster change than had been foreseen at the beginning of the year, but even though the situation was extraordinary, the change is considered to be a permanent one in many ways.

It is certain that digital solutions will continue to gain ground, but those services which cannot be digitised will become even more important. The Bank is determined to remain number 1 for service and is convinced that the secret to success lies in providing service that is both personalised and digital.

The Bank has continued to focus on simplification and enhanced efficiency. An increasing number of teams of the Bank are adopting a lean methodology, and key Bank processes have been streamlined. Furthermore, the Bank is in the process of introducing further robotics, which are already implemented in the automation of processes relating to payment services.

The Bank has merged almost all of its back-office projects into a single division at one location called "Back Office". This has enabled considerable streamlining as similar tasks are now carried out in the same location.

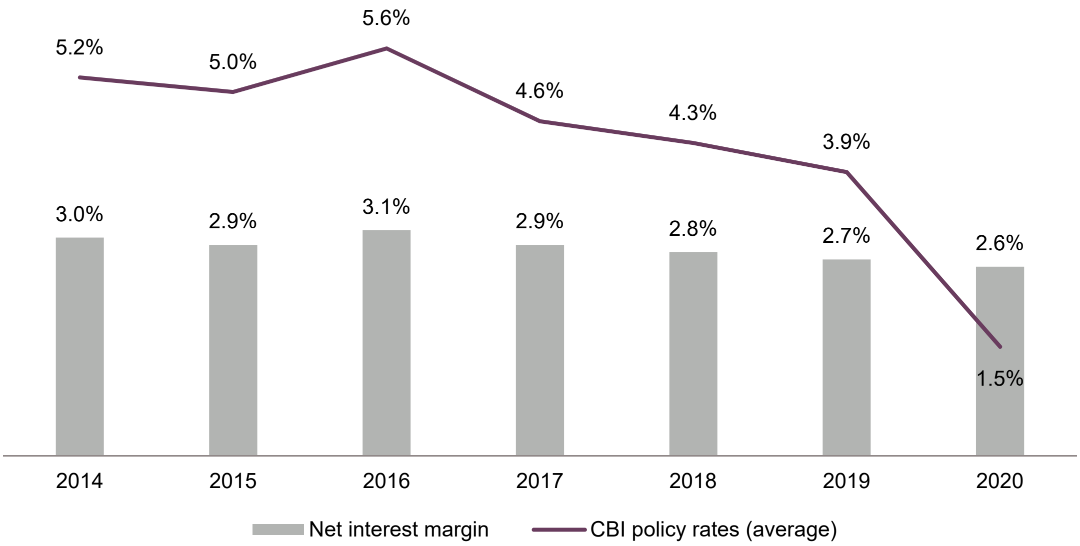
The Bank has established a product centred approach to digital development that targets innovation. The aim is to respond more quickly to customers' needs and ensure effective and productive cooperation between the business divisions and the Bank's IT team. Product teams are led by product managers from the business divisions. The business divisions set goals and strategies for the product teams and participate in product development.

A single team is responsible for the strategy, design, development, and operation of each product, which simplifies communications, improves product quality and enhances operational sustainability.

On track toward optimised pricing

Clear capital management and pricing strategy have protected the Bank's margin despite the challenges presented by the low interest rate environment. A clear strategy for asset management and pricing in line with the Bank's objectives, together with successful implementation of the strategy, supports appropriate pricing decisions enabling the Bank to offer the right products at appropriate prices. A well-defined pricing structure has led to more price efficiency and has proven essential in response to a sharp move to a low interest rate environment. A clear presentation of price information in systems for various types of customers has also expedited processes relating to interest rate changes, product development and loan applications. In this respect, the Bank has emphasised using data more effectively for preparation of pricing models and measurement of compliance with the Bank's profit objectives. As interest rates are expected to rise, the positive impact of these initiatives is expected to continue to benefit the Bank's margins.

The graph below demonstrates the Bank's ability to maintain relatively stable net interest margin in the face of a declining interest rate environment.



Focused build-up of strategic advantage

Three of the Bank's strategic themes centre on securing a competitive advantage for the future. These themes are: (i) being a data powerhouse; (ii) having a successful position in an open banking environment; and (iii) being a leader in sustainability.

Data powerhouse

The Bank recently updated its technology strategy in order to sharpen focus on data and data utilisation. The Bank placed stronger emphasis on using data intelligently to ensure efficiency in serving customers from the very start to the end of the customer journey. This entails harnessing valuable data in order to understand the needs of the Bank's customers and offering targeted services, products and prices. The Bank's chatbot, Fróði (powered by boost.ai), is a good example of data harnessing, as Fróði is always learning and adding on knowledge based on the queries received from customers.

Position in an open banking environment

The Bank has opened a developer portal for its open banking partners to connect with the Bank, and the first open application programming interfaces (API) are now accessible to the Bank's partners. In 2020, the Board of Directors and the Executive Committee approved a strategy on the Bank's position in an open banking environment. Under this strategy, the Bank will begin by concentrating on opportunities relating to lending.

Leader in sustainability

The Bank has been at the forefront of sustainability and has been a priority of the Bank since 2009. As a leader in sustainability, the Bank seeks to capture increased customer, employee and stakeholder interest in sustainability by offering and further strengthening its brand image as a sustainability lender. Strategic benefits of the Bank's sustainability framework include:

- Improved risk management;
- Lower costs, diversified access to capital;
- Increased innovation and growth;

- Enhanced brand image;
- Stronger business relationships; and
- Increased ability to attract and retain qualified personnel.

The timeline below indicates the key steps in the Bank's history where it has been a leader in ESG initiatives.

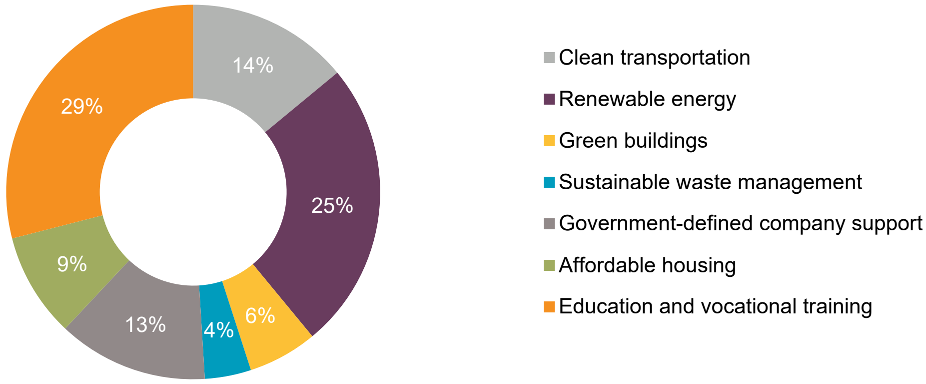
The Bank introduced its Sustainable Financing Framework in 2020 aimed at supporting the mobilisation of capital to sustainable projects and operations through offering sustainable loans for projects, including smaller hydropower plants, geothermal power plants, wind and solar power plants, and loans to schools promoting job creation for women and disadvantaged groups. The Bank's processes and administrative structure relating to sustainability were strengthened through the creation of the Bank's Sustainability Committee, in keeping with the Bank's determination to realise its ambitious sustainability objectives and be a leader in the field. The Bank has set out key sustainability goals for 2025, including:

- becoming carbon neutral in its operations, which it achieved in 2019;
- offering customers green and sustainable products;
- balancing gender ratios through all of the Bank's operations;
- creating a working culture that celebrates diversity and inclusion;
- working with suppliers and partners that champion sustainability;
- assessing and publishing sustainability risk and defining internal decision-making; and
- placing special emphasis on four of the UN Sustainable Development Goals, which are 4: Quality Education; 5: Gender Equality; 9: Industry, Innovation and Infrastructure; and 13: Climate Action.

The Bank also has sustainable product offerings for customers including the green car financing offering through Ergo as well as the Green Bonds fund introduced as a savings option via Iceland Funds. Partnerships with Storebrand investment management provide customers the option of three green investment funds in Iceland.

In February 2021, the Bank published the first Allocation and Impact Report for Íslandsbanki's Sustainable Financing Framework. The report gives an overview of the first three months of the implementation and reports on the impact of the eligible assets already approved under the Framework.

The graph below illustrates the Bank's sustainability instruments and allocations in 2020, as well as the use of proceeds from the sustainability bonds issued. The Bank issued ISK 49.7 billion of sustainable bonds in 2020, of which approximately ISK 25 billion had been allocated to eligible projects as at 31 December 2020. The pie chart below shows the use of proceed split by project category as per the categories outlined in the Bank's Sustainable Financing Framework.



In 2021, the Bank's objectives are to complete the initial assessment of financed emissions using the standard adopted by the Partnership for Carbon Accounting Financials, to finalise loan portfolio classification based on its Sustainable Financing Framework and to continue to market new sustainable products.

Finally, the Bank's strategy regarding gender equality has also been effective in ensuring gender equality at the management level, with a gender ratio in the Bank's management team always at 40:60 women:men or greater. The Bank's strategic ambition is to remain a global leader in gender equality across all operations, with plans to increase the number of women in IT and the Corporate & Investment Banking division. The Bank's gender equality policy seeks to ensure equal wages, and currently the gender pay gap at the Bank is 1.14%, which is below the 5% threshold set by the Icelandic Association of Business Women, FKA. The Bank takes systematic steps toward diversity, empowerment and equal rights of all groups in alignment with the Gender Autonomy Act, and the Bank has signed the UN Global Compact's Women's Empowerment Principles and is Iceland's main banking partner to UN Women in Iceland.

For more information on the Bank's sustainability efforts, see "*Strengths–The Bank is a sustainability frontrunner in the Icelandic financial services industry with an ESG-ingrained culture*".

Current Trading and Recent Trends

The Group's trading performance since 31 March 2021 has exceeded the Bank's expectations. Net interest income in April was comparable to previous months. The Bank's loan book has grown notably in April, reflecting growth in lending to corporates and continuous growth in mortgages. The cost base has followed trends observed in the three months ended 31 March 2021. Loan impairments were positive in April 2021, based on management accounts, and first draft management account numbers for impairments in May 2021 indicate positive impairments in that month. The near term outlook for impairments is favourable if the pick-up in tourism and in the economy follows current trends. It should however be noted that due to the forward looking nature of the IFRS 9 accounting standard for impairments, adverse movements in the economy and for specific borrowers can have a rapid negative impact on the accounts. Furthermore, the ROE for April was in excess of disclosed financial targets, based on unaudited management accounts. In May 2021, the Central Bank of Iceland announced an increase in its policy rates from 0.75% to 1.0%. The Bank has adjusted its deposits and lending rate, taking this decision into account, and expects that this will have a positive impact on net interest income. In addition, since 31 March 2021:

- the Bank has decided to donate a part of its art collection to one or more domestic museums. In total, around 200 pieces of art will be donated. Subject to decisions on the exact accounting principles for the Bank's art holdings, the donation may lead to insignificant expenses or revenues in the Bank's income statement;

- the Bank has been in discussions with the Icelandic Government on the potential acquisition of the Icelandic Government on Auðkenni hf. ("**Auðkenni**"), currently an associated company in the Bank's financial statements. In parallel the Icelandic Government is in comparable discussions with all other shareholders of Auðkenni. Although still uncertain, it is assumed that these discussions will result in a sale of shares of Auðkenni. The Bank believes this will not have a material impact on its operations or financials;

- following a regular review of the Bank's LCR measurement methodology, the Bank has identified certain issues where more than one interpretation of the Central Bank of Iceland's LCR rules is plausible, resulting in different results for the LCR at each point in time. The Bank has shared its observations with the Central Bank of Iceland and is expecting guidance shortly, which may result in a change in the Bank's measurement methodology. The change, if implemented and other things held constant, would result in a higher LCR ratio; and

- a legislation change is being discussed in the parliament which, should it be approved as currently proposed, would provide for tax deductibility of interest on AT1 instruments. Accordingly and subject to reviewing the final legislation and ongoing market conditions, the Bank may explore undertaking an AT1 issuance within a short period of time.

Further, the regular annual SREP process is ongoing with the FSA which will result in a regular revision of the overall capital requirements for the Bank. The Bank assumes that draft results will be presented to the Bank mid-June 2021 and a final decision by the end of June 2021. The Pillar 2-R requirements are expected to increase temporarily as a result of COVID-19. Based on the Bank's own assessment (ICAAP), the increase should be less than the reduction of the counter-cyclical buffer from 2% to 0%. The Central Bank of Iceland will decide on if and how the capital requirements for the Icelandic banks are made public. The Bank has disclosed the SREP capital requirement through its Annual Financial Statements and the Pillar III report.

Other than as described above, there has been no significant change in the financial position or performance of the Group since 31 March 2021, the end of the last financial period for which financial information was prepared.

Financial Targets

The Board of Directors has adopted the following financial targets. For additional information on the Bank's dividend policy, see "*Shares and Share Capital—Dividends and Dividend Policy*".

The Bank's financial targets set forth below constitute forward-looking statements that are subject to considerable uncertainty. The financial targets are based upon a number of assumptions relating to, among other things, the development of the banking industry, business, results of operations and financial condition. None of the Bank's independent auditor, nor any other independent accountants, have applied, examined or performed any procedures with respect to the financial targets, nor have they expressed any opinion or any other form of assurance on the financial targets or their achievability. The financial targets constitute forward-looking statements and are not guarantees of future financial performance. The Bank's business, prospects, financial position and results of operations, and the development of the banking industry and the macroeconomic environment in which it operates, may differ materially from, and be more negative than, those assumed by the Bank when preparing the financial targets set forth below. The existence of the financial targets should not be interpreted as an assurance or guarantee that financial targets can or will be met by the Bank. While presented with numerical specificity, these financial targets are based upon a number of assumptions. The financial targets reflect the Bank's subjective judgements in many respects and thus are susceptible to multiple interpretations and periodic revisions based on actual experience and business, economic, financial and other developments. Accordingly, such assumptions may change or may not materialise at all. In addition, unanticipated events may materially or adversely affect the Bank's actual results or operations and financial performance in future periods, whether or not the Bank's assumptions relating to future periods prove to be correct. As a result, the Bank's ability to reach these financial targets is subject to uncertainties and contingencies, some of which are beyond its control, and no assurance can be given that the Bank will be able to reach these targets or that its financial position or results of operations will not be materially different from these financial targets. See "Presentation of Financial and Other Information—Forward-Looking Statements" and "Risk Factors".

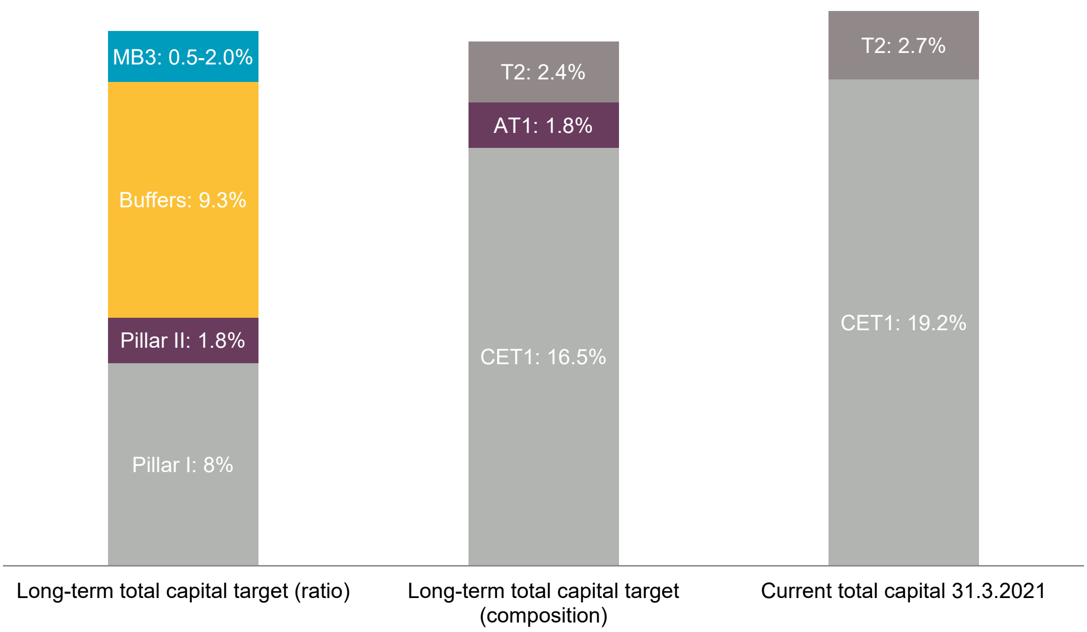
None of the Bank, the Bank supervisory board or management board members, senior management or any of their respective affiliates, advisers, officers, directors or representatives can give any assurance that the financial targets will be realised or that actual results will not vary significantly from the financial targets. Investors should independently assess whether or not they believe the financial targets to be reasonable or achievable and should carefully evaluate whether investing in the Offer Shares is appropriate, bearing in mind personal circumstances and the information included in this Prospectus, particularly considering the *information described in "Risk Factors". Also see "Presentation of Financial and Other Information—Forward-Looking Statements".*

Return on equity

For the year ended 31 December 2020, the Bank's reported return on equity was 3.7% (or 6.2%, when including 2.5% of adjustments normalising for ISK 6.1 billion of impairments on loans to the tourism sector that were transferred to Stage 2 in 2020 because of COVID-19), and, on an annualised basis for the three months ended 31 March 2021, was 7.7%. The Bank aims to deliver a return on equity between 8-10% by 2023 and in excess of 10% in the long term. This is based on the average expected risk-free rates through the business cycle. The Bank has identified a clear path to ROE improvements, supported by a clear action plan and economic recovery. These steps include:

- normalisation of credit losses (the two-year average cost of risk of the Bank for 2019 and 2020, excluding the effects of COVID-19, which amounted to 63 basis points in 2020, was 35 basis points; cost of risk on an annualised basis for the three months ended 31 March 2021 amounted to 20 basis points, consisting of 37 basis points attributable to COVID-19 and -17 basis points for other risk);
- increasing risk-free rates (CBI current account rates, average for the year forecast, are estimated to decrease from 1.25% in 2020 to 0.5% in 2021 and then increase to 3.25% by 2025 (*source: Íslandsbanki Research*));
- growing net fee and commission income, which is expected to outpace growth in risk exposure amount;
- achieving cost efficiencies through continued improvements in digital uptake and branch optimisation, combined with contained cost inflation; and
- implementing capital optimisation through the distribution of surplus capital and the optimisation of capital composition.

Applying the current regulatory requirements and minimum capital target of the Bank, as at 31 March 2021, the chart below outlines the additional scope for excess capital.



(1) Assuming a long-term counter-cyclical buffer of 200 basis points.

Cost-to-income ratio

The Bank's cost-to-income ratio for 2020 was 54.3%, compared to 58.8% for 2019 and 62.6% for 2018 (excluding the impact of Borgun, which was sold in 2020, as well as the Bank Levy and one-off items) and was 52.0% for the three months ended 31 March 2021 (51.9% for the twelve months ended 31 March 2021). Its short-term target is to reduce its cost-to-income ratio to less than 45% by 2023. The Bank will rely on its continued investment in IT infrastructure and process efficiency to achieve these targets, which assume that costs will remain broadly flat over the next three years.

Capital ratios

CET1 capital ratio

The Bank's CET1 ratio as at 31 December 2020 was 20.1% and 19.2% as at 31 March 2021. Based on current regulatory requirements and management buffer of 50-200 bps, the CET1 capital ratio target range of the Bank is currently 13.2-14.7%. The long term CET1 target is in excess of 16%, in line with expectations of an increase in the countercyclical buffer, which was 2.0% prior to COVID-19. The Bank intends to start paying out a part of its excess capital in parallel with its ordinary dividend payable for 2021, with the amount to be decided at that time.

Total Capital Ratio

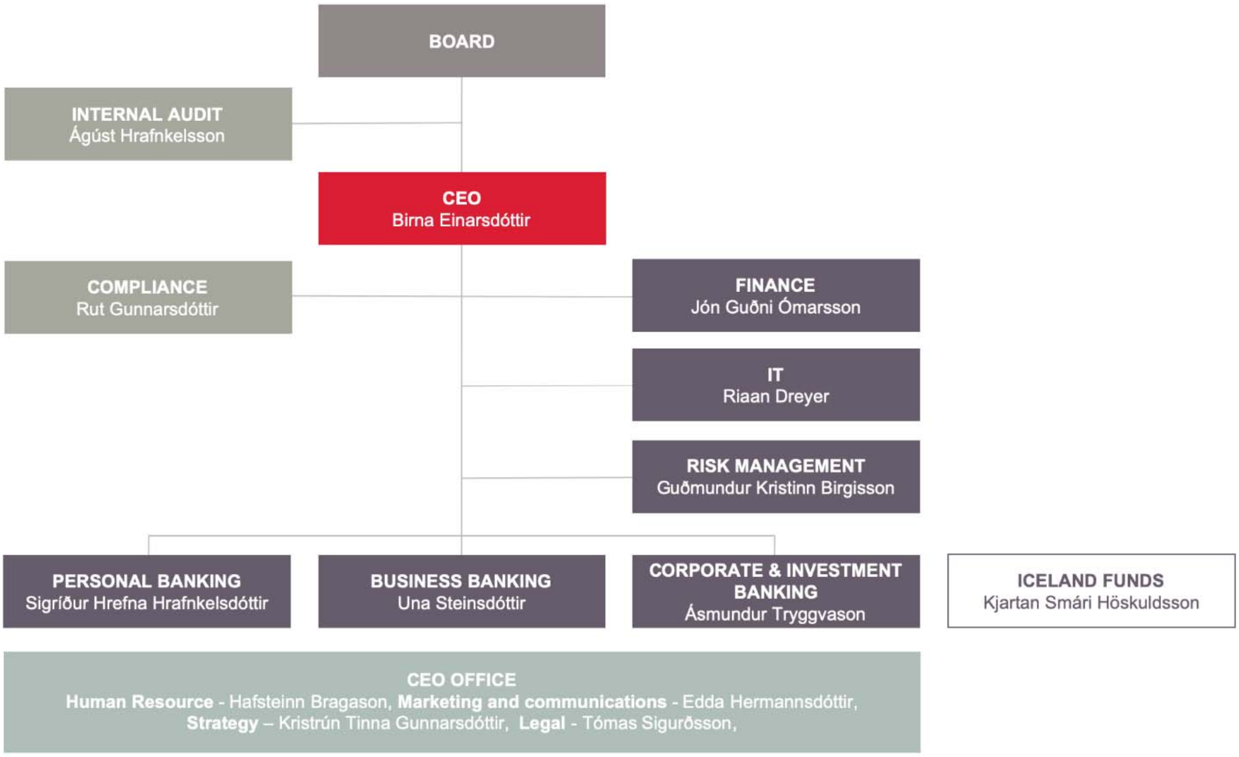
The Bank's total capital ratio as at 31 December 2020 was 23.0% and 21.9% as at 31 March 2021. Based on current regulatory requirements and management buffer of 50-200 bps, the total capital target range of the Bank is currently 17.5-21.0%. The long-term target range is 19.5-21.0%, in line with expectations of countercyclical buffer moving from 0% to 2%. The Bank intends to issue an AT1 instrument within the next 6-18 months, or potentially sooner, assuming favourable market conditions (including tax deductibility of such instruments).

Dividend pay-out ratio

Based on the then-applicable regulatory requirements, the Bank is targeting to pay out approximately 50% of earnings as a base dividend. The Bank will focus on excess capital to support further dividend payments, buybacks and/or ROE enhancing growth. The Bank anticipates additional capital return to approach capital targets over the medium term.

Business and Divisions

The organisational structure of the Bank is as follows:



The Bank has three main business divisions as follows:

Personal Banking offers a full range of financial services for individuals and households, such as lending, savings and payments. The Bank's customers are increasingly taking care of their day-to-day banking via digital solutions, such as mobile apps, online banking and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services and contact the contact centre.

Business Banking provides comprehensive banking services and versatile banking products to SMEs, such as lending, saving products and payment solutions. Business Banking operates through business banking centres in Norðurturn/Kópavogur and Akureyri and branches strategically located around Iceland. Ergo, the Bank's asset-based financing unit, is also a part of Business Banking. Customers also have full access to their business and day-to-day operations via online banking and app. The Business Banking contact centre is operated from Norðurturn/Kópavogur, the headquarter branch. According to Gallup surveys, the Bank has been voted market leader in the previous 11 years and consistently scored highest in service amongst peers according to the same surveys.

Corporate & Investment Banking provides comprehensive universal financial and investment banking services to large companies, municipalities, institutional investors, and high net worth individuals. The product and service offerings are a comprehensive range of financial and investment banking services, including lending, securities and currency brokerage, corporate advisory services, private banking services and sales of hedging instruments. The division is focused on building and maintaining relationships across all industry divisions within Iceland. Outside of Iceland, the division has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Other divisions

Treasury and Proprietary Trading is responsible for funding the Bank's operations, managing the internal pricing framework, balance sheet management and relations with investors, financial institutions, stock exchanges and rating agencies.

Cost centres comprise the CEO's office (Human Resources, Marketing & Communications, Strategy, and Legal), Finance excluding Treasury and Proprietary Trading, IT, Risk Management and Compliance. Group Internal Audit is included in cost centres; however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank's Board of Directors.

Subsidiaries include Íslandssjóðir hf. (Iceland Funds), Allianz Ísland hf. and other less significant subsidiaries.

The tables below set forth operating income, profit (loss) before tax, and total assets for each reportable division and the total assets for each reportable division as at the dates and for the periods indicated.

	As at and for the year ended 31 December 2020 in ISK millions						
	Personal Banking	**Business Banking**	**Corporate & Investment Banking**	**Treasury & Proprietary Trading**	**Cost centres**	**Subsidiaries, eliminations and adjustments**	**Total**
Operating income	14,103	12,503	13,527	1,997	79	944	43,153
Profit (loss) before tax	2,801	446	4,700	1,663	3	(289)	9,324
Total assets	423,094	234,779	354,748	320,880	10,893	(203)	1,344,191

	As at and for the year ended 31 December 2019 in ISK millions						
	Personal Banking	**Business Banking**	**Corporate & Investment Banking**	**Treasury & Proprietary Trading**	**Cost centres**	**Subsidiaries, eliminations and adjustments**	**Total**
Operating income	15,159	12,553	12,491	2,085	1,953	924	45,165
Profit (loss) before tax	3,071	4,244	5,072	(1,146)	1,827	(335)	12,733
Total assets	332,818	233,927	335,135	267,386	10,648	19,576	1,199,490

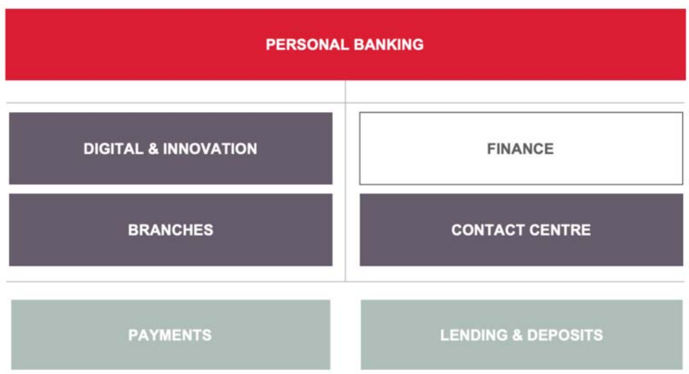
	As at and for the year ended 31 December 2018 in ISK millions						
	Personal Banking	**Business Banking**	**Corporate & Investment Banking**	**Treasury & Proprietary Trading**	**Cost centres**	**Subsidiaries, eliminations and adjustments**	**Total**
Operating income	14,511	11,306	11,350	4,610	76	3,134	44,987
Earnings (loss) before tax	3,802	5,595	5,954	2,203	(1,580)	(1,507)	14,467
Total assets	300,761	222,759	323,290	252,989	8,056	22,548	1,130,403

Personal Banking

Overview

Personal Banking offers a full range of financial services for individuals and households, such as lending, savings and payments. Key products include a wide range of loans and savings options for customers as well as simple and effective payment solutions. This includes savings, lending, insurance products, and different payment options via the Bank's various distribution channels, including the mobile app, online banking, branches, the contact centre, e-mail and the online chat function. The Bank's personal banking customers can conduct their banking business 24/7. Some of these distribution channels such as ATMs, mobile app, online banking, and online chat bot functions are also available 24/7. As at 31 December 2020, the Personal Banking division had over 135,000 active customers and funded over 15,000 mortgages in Iceland with 190 employees (excluding temporary employees whose contracts terminated at 31 December 2020). The Personal Banking division's focus is to simplify the customers' daily financial activities by being the preferred financial partner offering easy to use digital customer journeys as well as a strong local branch presence.

The chart below sets forth the organisational structure of the division.



Strategic Priorities

The mortgage portfolio is a fundamental aspect of the Bank's Personal Banking division with 88% of the loan balance as mortgages as at 31 December 2020. The Personal Banking division aims to increase its share in mortgage loans over the next five years while keeping the current margins at similar levels. The Bank also aims to be more cost efficient by lowering cost and increasing revenue.

Personal Banking aims to continue providing best-in-class mobile solutions and develop new and existing products with the goal of providing customers full digital coverage of all offerings.

The Bank believes that the Personal Banking division is well-positioned to meet fast changing customer demand for sustainable products and that, through pricing and further efficiency the right fundamentals are in place for balance sheet growth. The key future initiatives of the division include:

- Expand digital capabilities to be able to offer complete product and service offering digitally;
- Increase the mortgage portfolio and digitisation of the process;
- Improve customer targeting through the use of more advanced data and analytics;
- Extend the current product offering through partnerships and open banking initiatives; and
- Finalise end to end digitalisation of key customer journeys.

Customers

As at 31 December 2020, the Personal Banking division had an estimated 135,000 active customers and now finances more households in Iceland than it has before. The Personal Banking division enjoys a loyal and relatively stable customer base in Iceland. The Bank measures customer satisfaction on the basis of net promoter scores and other traditional customer satisfaction measures for its most important customer services.

Products and Services

The table below sets forth the financial products and services offered by the Personal Banking division.

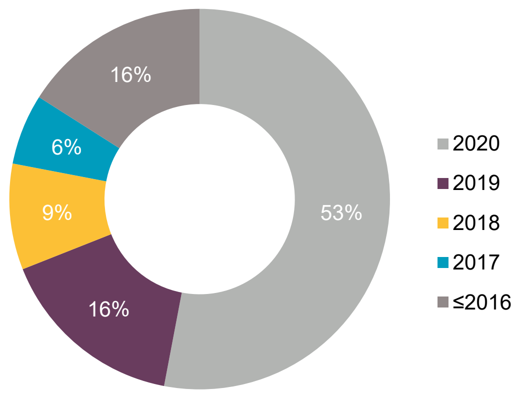
Loans	**Savings Products**	**Payment solutions**
Mortgages (indexed, unindexed, variable rates, fixed rates, first buyer add on)	Saving and checking accounts	Checking account / debit cards
Bonds (with insurance, under ISK 2 million, etc.)	Private pension plans (third-pillar pensions)	Credit card
Overdraft	Mutual funds	Kass app, Apple Pay, Fitbit

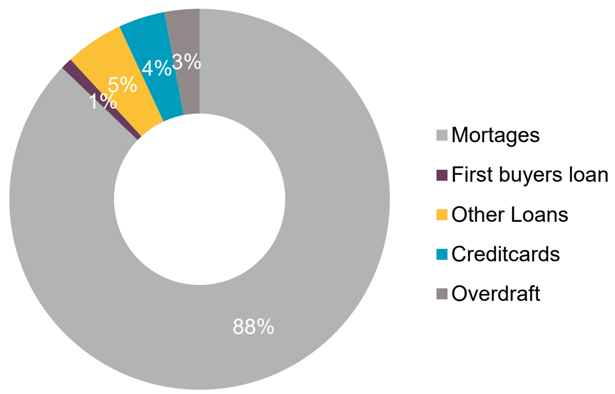
Loans

This division offers a wide range of loans for individuals, from overdraft accounts to mortgages, with a fully digitised and automated credit assessment process. As at 31 December 2020, the Bank's loan portfolio for Personal Banking was ISK 420 billion.

In 2020 the Central Bank of Iceland's interest rates were lowered by 2.25% to 0.75%. Low rates led to an increase in refinancing in 2020 and, in turn, propelled significant profitable growth resulting in an increase of the Bank's market share in residential mortgages to 19.2% in 2020 from 15.9% in 2019.

The graphs below present the composition of the Personal Banking loan book as at 31 December 2020 in terms of year of origination and product split.





As at 31 December 2020, mortgages represented 88% of all outstanding loans of Personal Banking. As at 31 December 2020, mortgages increased by ISK 96 billion which resulted in a 33% increase in the balance. 53% of the Bank's current mortgage portfolio were issued in 2020 in part due to a record number of refinancing of older mortgages as rates decreased. 84% of the mortgage loan portfolio was issued in the last four years. As at 31 December 2020, the mortgage balance portfolio was about 50% indexed, but this proportion is expected to decrease as the demand for non-indexed loans is high.

The Personal Banking division also offers mixed CPI-linked and non-CPI-linked mortgage loans, allowing customers to select the type of mortgage loan that best suits their risk appetite and repayment ability.

Customers of the Bank are also able to apply for a loan of up to ISK two million in a matter of minutes through the Bank's mobile app, which allows customers to apply for a loan.

Digitisation has helped decreased overall time to process customer requests, which is an important factor as mortgage turnover has increased significantly. In 2020, 29% of overdrafts were automatically approved.

Recent product developments include the following:

- a fully digital and automatic credit score evaluation and refinancing of mortgages was launched, resulting in a total of 10,320 applications processed through the channel in 2020. Through the programme, the customer permits the Bank to gather information from third parties, such as financial institution and tax authorities and subsequently receives a credit score within three minutes, and

- a fully automated loan application including the customer's selection of a property, the selection of a loan structure and the submittal of the loan application. Applicants can track the status of their application and all signatures in the process are now electronic. In 2020, 30% of mortgage applications were automatically approved, and overall 12.7% of loan applications were automatically approved. The low approval rate is mainly as a result of the applicant pool's poor credit rating. Credit defaults have, however, stayed low, and the majority of the defaults have been in low risk categories.

Savings Products

This division offers saving options such as saving and checking accounts, private pension plans (third-pillar pensions) and mutual funds. In 2019, a fully automated onboarding solution was launched for new customers and in 2020, 75% of new saving and checking accounts were done via the digital channels. From early 2020, customers have been able to open custodian accounts via the digital channel and begin investing in funds and securities, which has proven to be a well-received solution especially as interest rates have decreased. In 2020, over 95% of all individuals opening new custodian accounts did so through the digital solution.

Historically, deposits from individuals have been stable and customers of the Icelandic banks have tended to keep their savings with their main bank. However, the increase in the Bank's market share of mortgage loans has also opened a window to increase the Bank's market share in savings, including deposits, mutual funds and pensions plans. The result of this has not been fully realised, although as the Bank's market share in savings remained stable in 2020, after a 0.5% decrease in market share to 31.3% in 2019 due to new competitors entering the market offering higher deposit rates.

In 2020, deposits of households in Iceland increased by 12% compared to 7.3% in 2019. This increase can be attributed to the impact of COVID-19, i.e. less spending on items such as travelling and lower interest payments on loans. The increase in deposits in the Personal Banking division for the Bank was 11.7% in 2020 to ISK 322.6 billion and therefore the increase is in line with the total increase of the system.

In 2020, the Icelandic government introduced a plan that allowed individuals to withdraw up to ISK 12 million from a private pension plan over a 15-month period. Despite the implementation of this plan, the private pension plan assets in the Bank increased by 7.7% in 2020, and customers increased from 13,800 in 2019 to 15,500 in 2020. Over 95% of all such private pension plans in the Bank are sold via digital channels, representing a 41% increase compared to 2019. The Bank's private pension plan was the first in Iceland to invest in green Icelandic funds and investment plans following the UN's Principles for Responsible Investment (PRI).The Bank is also the only bank in Iceland that has partnered up with well-known international and respected fund and asset management companies such as Storebrand and Vanguard. In particular, the partnership with Storebrand offers sustainable investment options.

Payment solutions

This division offers simple and effective payment solutions in the front ranks of payment market products. The Bank has a 40% share of the payment solutions market, including credit cards. The Bank's customers are able to access all services relating to payment cards through digital distribution channels, making the service a simple and natural part of their everyday lives. Around the turn of the century, every Icelander had more than 2.5 plastic cards in their wallet. Recently, however, the industry has seen a significant behavioural shift from plastic cards to mobile and wearable payments. The Bank was the first bank in Iceland to enable payments with wearables.

The Bank has an exclusive contract with MasterCard, which means that all debit cards, gift cards and credit cards issued by the Bank are MasterCard branded. The Bank's share of the credit card market is 40%, whereas its share of the debit card market share is around 32%. Total card volume in 2020, for the Bank, was ISK 350 billion. The most popular payment method in Iceland is currently Apple Pay. In 2020, contactless payments increased by 50% in Iceland (69% of payments in the Personal Banking division were contactless) and are likely to continue to increase in the future.

Other payment solutions allowing customers to change their credit limit and manage payment instalments have been successful as well. Between 75-80% of the Bank's customers use the Bank's mobile app to access these payment solutions every month.

The Bank's fintech collaborations with Meniga and Memento have added value to the Bank's customers as well. For example, through Fríða, which was developed as part of the collaboration with Meniga, customers are able to get cash back every month into their account or monitor their carbon footprint. Additionally, the Kass app, one of the Bank's distribution channels and a collaboration with Memento, allows customers to conduct P2P transactions, split bills and request payments.

Contact Centre

The Bank's contact centre opened in 1997, acting as a switchboard/service centre for the Bank. Previously, customers could request their balance status and transfer or pay unpaid bills using the contact centre. In case the inquiry was too complex the Bank employee would forward the call to the branches. Currently, the contact centre can address more of the customer's issues/requests as it acts as a one-stop shop for all customer inquiries. The contact centre focuses on advising and assisting customers by phone, e-mail or chat. The "help the customer to help themselves" features introduces to the customers to all the digital solutions that the Bank offers. Customers obtain direct access to technical specialists when they are facing issues and need guidance and support using the online bank, the Bank's mobile app and/or the ATMs. Incoming phone calls have increased slightly between 2019 and 2020 and webchat traffic has increased 34% between 2019 and 2020. In addition, an AI chatbot was launched in 2020, in collaboration with boost.ai, a Norwegian fintech partner, which allows customers to get tailor made answers 24/7. This AI chatbot solves over 50% of all webchat traffic, with a satisfaction score over 90%.

In 2018 Kreditkort hf.'s contact centre, which specialised in credit card issues, merged with the Bank's contact centre. This was done as a result of the closure of Kreditkort hf., a wholly owned subsidiary of the Bank. Due to the merger, the contact centre acquired a higher level of expertise knowledge with specialist in credit cards and claims/chargeback. All chargeback/ claims are currently processed in the contact centre. The contact centre also provides support for the on-boarding process.

In 2020, the contact centre received around 563,500 queries via phone, e-mail, or online chat. The Bank's chatbot, Fróði, is trained by employees in the contact centre and has been programmed to provide bank assistance and guidance to individuals and corporate customers, resulting in zero waiting time for those inquiries.

In 2020, the Bank also introduced priority telephone lines for senior citizens and for mortgage-related inquiries.

Digital solutions

In 2018, an increased focus was put on digitalisation within the Personal Banking division in order to meet a growing demand in the market and improve both competitiveness and operational efficiency of the Bank. As a result, investments in physical services were reduced. Historically, the Bank has been on the forefront of retail banking technology in Iceland, which was the first to offer ATMs, online banking (eighth globally) and a mobile banking app. To prepare for a new era, the Bank's digital front-end solutions have been adapted to a modernised service driven architecture, which has allowed the Bank to act quickly to changes in customer demand and add new offerings to its main digital channels without extensive delays.

All key products (accounts, loans, investments and cards) can now be bought online through the Bank's onboarding solution, a digital way to offer products to customers, and can be accessed on the Bank's website. In 2020, retail customers visited the Bank's main digital channels (online bank and mobile app) over 31 million times and there were 90,000 active customers using the new Bank mobile app, with the user numbers steadily growing month by month. Approximately 99% of all new product orders (accounts, loans and cards) are now processed via the Bank's online channel. A new addition to digital onboarding (digital onboarding of custody accounts) was added in February 2020. Over 75% of all individual trades are digital with a year on year increase of 41%. The current ratio of new contracts is 67% compared to 33% renewed.

Throughout 2020, a number of legacy challenges were solved with a view to ensure that the online bank would operate without any major operational issues and on a service driven architecture. The online bank remains the main channel for investments, with plans to add investment products to the mobile solution in 2021.

Combined, the digital solutions capture all services that have historically been offered in the Bank's branch network and would allow the retail bank to operate without a physical presence. Partnering in areas such as loyalty system, account aggregation, peer-to-peer, chatbot and more, has allowed the Bank to gain momentum in delivering state of the art services and meet customer demand for digital products.

Operations and Distribution Capabilities

The table below sets forth certain operational data for the Personal Banking division as at 31 December 2020:

Market share of individual customers (*source: Gallup*)	31%
Total number of active customers (individuals)	>135,000
Total number of branches	12
Number of full-time employees[(1)]	190
Loans to customers	ISK 420 billion
Deposits from customers and credit institutions	ISK 325 billion

(1) Excluding temporary employees whose contracts terminated at 31 December 2020.

The Personal Banking division generates operating income through the provision of financial products and services to retail customers, on which the Bank earns interest income and fee and commission income. Operating income for the Personal Banking division was ISK 14,103 million, ISK 15,159 million and ISK 14,511 million for the years ended 31 December 2020, 2019 and 2018, respectively. As at 31 December 2020, 2019 and 2018, the Personal Banking division's customer loan portfolio amounted to ISK 419,882 million, ISK 329,265 million and ISK 299,429 million, respectively, and the total amount of deposits with the Personal Banking division amounted to ISK 324,815 million, ISK 290,894 million and ISK 275,265 million, respectively.

The table below sets forth certain operational data for the Personal Banking division as at the dates and for the periods indicated.

As at and for the year ended 31 December

	2020	% change	2019	% change	2018
Number of active online banking users	91,530	-1.0%	92,460	-0.9%	93,296
Number of active Bank mobile app users	86,798	11.8%	77,637	19.6	64,914
Number of interactions through ATMs (000s)	84,356	-18.4%	103,419	-7.2%	111,446
Number of visits to branches (000s)	305	-43.6%	540	-21.9%	691
Number of calls to the contact centre (000s)	275	0.4%	274	-14.4%	320
Number of assets per FTE	1.7	13.3%	1.5	15.4%	1.3

The table below sets forth the range of services available to the Personal Banking division's customers through online banking, the Bank mobile app and ATMs.

Online Banking	Bank Mobile App	ATMs
Current accounts	Electronic overview	Balance check
Savings	Balance check	Deposits and withdrawals
Loans	Payments	
Money transfer	Money transfer	
Payments and payment scheduling	Credit / debit cards	Account statement
Credit / debit cards, limits and bill split	Overdrafts / credit card limits	Money transfer
Overdrafts	Bill payments / split, in real time, simultaneous	Currency withdrawal
Loan payments	Announcement of new bills	Bill payments
Domestic equities transactions	Freeze card	Pin changes (both credit cards and debit cards)
Financial overview, pension, insurance and tax	Retrieve pin	Mobile top up
	Access to loyalty system	Pay unpaid bills
	Loans overview	Mobile top-up
	Unpaid bills	
	Electronic documents	
	Account aggregation	
	Open new accounts	

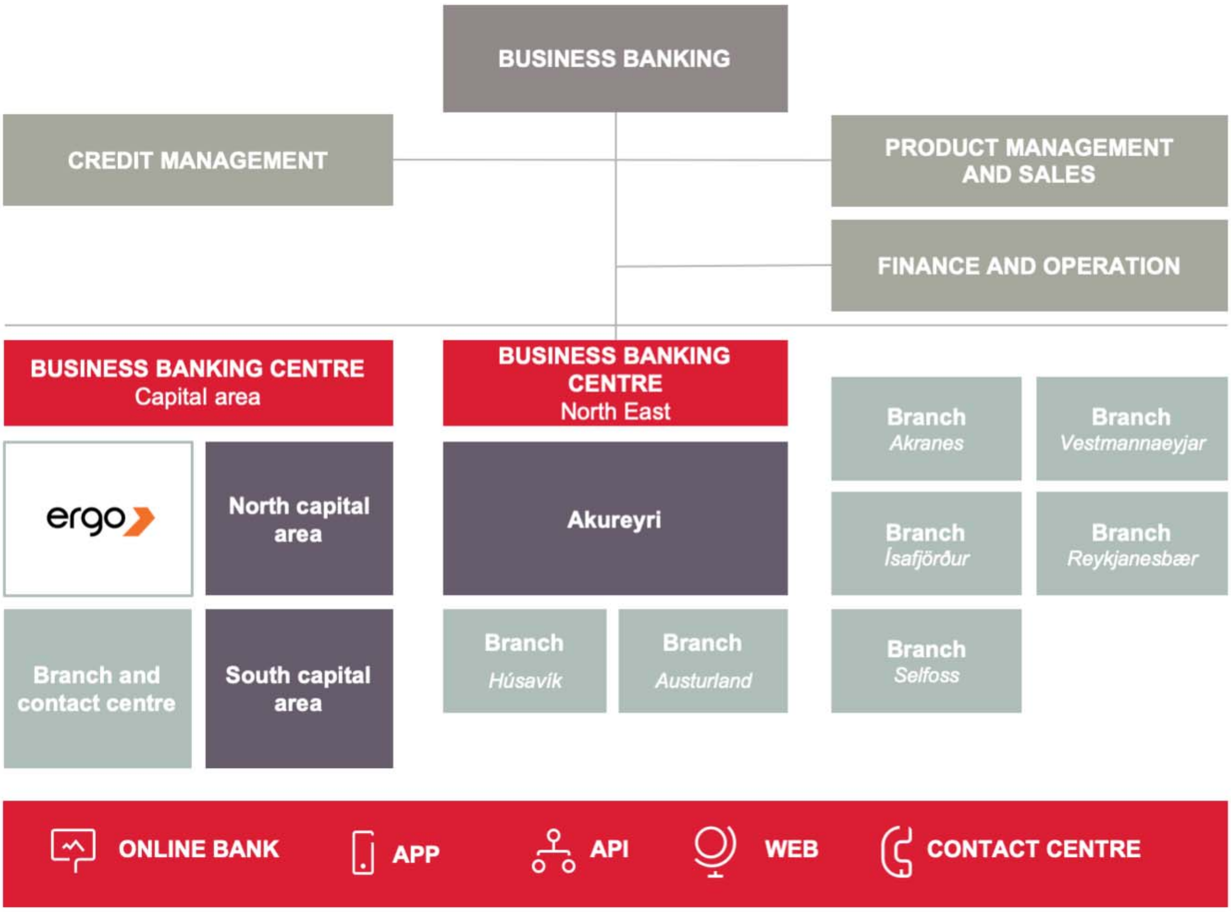
Business Banking

Overview

The Business Banking division provides comprehensive banking services and versatile banking products on service platforms to SMEs, such as lending, saving products and payment solutions offered through branches, via online banking and mobile app. The Bank provides these services through Iceland's most efficient branch network, while also operating on its separate brand, Ergo, in the asset-based financing sector. Business Banking serves the growing SME group in Iceland and has built up strong local relationships and expertise over the years. Business Banking works according to a decentralised structure where each business centre and branch is responsible for and shares its experience and expertise with its immediate community. While providing personalised services, the Bank has expanded access to digital solutions. For the last 18 years, customers have been able to conduct their daily banking activities via the Bank's corporate online bank which is the largest distribution channel. Last year, the Bank welcomed businesses to the mobile app, and at the end of March 2021, over 55% of active customers had already started using the app. Furthermore, customers can open accounts and credit cards via the Bank's website. The Business Banking division has repeatedly received the highest rating in service surveys among peers.

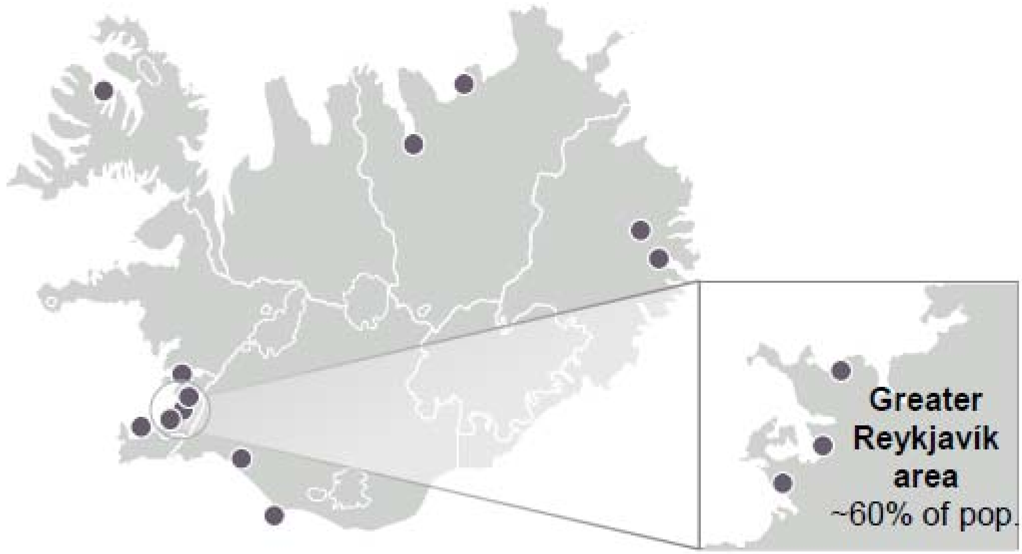
In 2020, structural changes were made within the Business Banking division. Services to SMEs in the capital area were merged into a single location business centre in Norðurturn, the Bank's headquarters. At the same time, the Bank significantly expanded the advisory services to SMEs, including the Business Banking contact centre in Norðurturn, with the aim of providing even better service and boosting output and efficiency. A Business Banking centre for North and East Iceland was also launched in Akureyri. Those changes allow all branches to draw from combined experience and provide better service to the Bank's customers. The division offers a strong customer-centric platform for SMEs.

The chart below sets forth the organisational structure of the division.



The Bank holds a strong total market share of 38% and 45% in the capital area (*source: Gallup survey, March 2021*), increased from 35% and 42% in 2020 (*source: Gallup survey 2020*). The Bank holds the highest net promoter score amongst peers, and 37% of new businesses say they would contact the Bank first if they were to start their business today (*source: Gallup survey 2020*). In addition, the Bank scores highest among peers regarding consultation and best in service, according to the same survey. Ergo's market share is the largest in the country, with 46% for new registered equipment and machinery financing and 49% for new rental car financing in 2020 (*source: Icelandic Transport Authority and Administration of Occupational Safety and Health and Íslandsbanki data*). In 2020, Ergo was the first choice for car financing by individuals, with 29% market share for new cars and 26% for new and used cars (*source: Gallup survey 2021*).

The map below shows the location of the Bank's branches and SME Business Banking centres.



Strategic priorities

The Business Banking division has a track record of successfully implementing strategic initiatives via communication and service strategies. The Bank has a clear strategy for achieving further growth and enhancing efficiency in its operations with the specific areas at focus set forth below:

<ins>Maintaining a leading position on the market</ins>

Business Banking has been a market leader in service and has a clear strategy for maintaining its position in the market. The best-in-class service is built on advanced and well-developed service strategy, which includes effective communication, a proactive approach, networking and targeted marketing and cross-selling. The structural changes made in 2020 provide the Bank additional scope for expanding market share. The Bank has implemented a customer relationship management system to log customer activity and enable front line staff to answer questions and provide relevant service in both branches and through the contact centre.

<ins>Strong risk culture and disciplined processes</ins>

The Business Banking division has a clearly defined risk appetite. Business Banking has a defined risk policy with targets and thresholds to manage concentration in the loan portfolio. The division has a strong risk culture with employees with an average experience in the banking sector of over 20 years. Pricing models are risk oriented and disciplined and lending decisions emphasise payment capacity over collateral. The loan portfolio is well diversified, with no legacy problems and negligible collateral gap for long-term loans.

<ins>Focus on sustainability</ins>

Through the Bank's sustainable financing framework and participation in green projects, the division is well positioned to meet fast changing customer demand for sustainable products. The first sustainable lending product in the Bank was green financing for car purchases launched in June 2020 through Ergo. In 2020, Tesla entered the Icelandic market and selected Ergo as its official partner in Iceland. Iceland ranks second in the world for the proportion of new electric cars sold. Ergo's green financing, covering cars that emit less than 50 grams of carbon dioxide under the Worldwide Harmonised Light Vehicles Test Procedure, was the first sustainable lending product offered by the Group, and Ergo was the first lender in Iceland to offer loans for electric bicycles and charging stations.

<ins>Focus on future growth</ins>

The diversified loan book has experienced disciplined financial growth. Focus has been on certain target groups as well as organised cross-selling. The Business Banking division has had a clear structure of cross-selling with other divisions within the Bank which the Bank aims to continue to utilise, for example, through the Corporate & Investment Banking division and through Ergo, for products of the asset-based financing unit of Business

Banking. The Bank focuses on maintaining long-term relationships with existing customers and attracting new customers with the aim of building new long-term relationships.

A large part of 2020 was dedicated to projects related to COVID-19, which included working closely with customers, being proactive and supportive and assisting them with COVID-19 loans and payment suspension. The Bank provided around 400 COVID-19 loans, under terms set by the Icelandic government for supporting companies impacted by COVID-19, the vast majority of which were granted exclusively using the Bank's digital platform. The Bank was able to deploy these loans quickly, within 85 days from the day the COVID-19 loans were introduced to the day of first pay-out by the Bank.

Improving customer experience

The Business Banking division relies on a relationship-based model with a proactive sales and multi-product approach driven by key performance indicators. The decentralised business model fuels growth in lending to SMEs by bringing the lending decisions closer to SME customers and resulting in faster processing times and a customised approach to individual lending decisions.

The Bank is working towards continuous improvement of service strategy and further development in digitalisation. The Bank has an ambitious roadmap for the next years, including integration of its on-boarding solution into its mobile app and online bank. The Bank also has additional fintech partnerships lined up and has plans for open banking. In order to achieve this, the Bank will continue to work closely with its fintech partners with the aim of becoming more efficient in its automated solutions and data-driven analytics.

In 2020, the Bank started collaboration with the fintech Payday. Payday specialises in simplifying business administration for freelancers and small businesses. Payday simplifies invoicing and payroll and creates an overview of the business.

The Bank has made it a priority to offer outstanding personalised service despite, the temporarily closed doors of the Bank's branches. The Bank has been aided in this effort through their digital services, which have been advanced significantly by COVID-19.

Customers

As at 31 December 2020, the Business Banking division had an estimated 11,200 corporate customers, 8,400 association/non-profit customers and 10,100 customers of Ergo. Ergo's customer base is largely built on the Bank's customers base. 50% of Iceland's *outstanding companies* are served by the Business Banking division. *Outstanding companies* are measured by Creditinfo based on the company's strength and stability measures. The Bank measures customer satisfaction on the basis of net promoter score.

Business Banking categorises customers by specific target groups to ensure customers receive both the right and appropriate service and products in line with their needs. The developed service strategy supports the maintenance of long-term client relationships.

Products and Services

Business Banking provides comprehensive financial products through its service platform, organised by customer choice with emphasis on a quality service to support customer growth.

A large part of creating exemplary service and strengthening the business relationship is to proactively contact the customers through visits and phone calls. The Bank conducts annual service surveys among its customers with follow-ups if necessary.

The table below sets forth the range of financial products and services offered by the Business Banking division.

Loans	**Savings Products**	**Payment solutions**
Overdraft	On demand checking and savings accounts	Debit cards
Term loans	Term savings accounts	Credit cards
Construction loans		Collection services
Invoice financing		Digital invoices
Domestic factoring		B2B web services
Guarantees and letter of credit		
Asset-based financing (Ergo)		
- Green financing		

- Hire purchase
- Car loans
- Car contracts
- Stock financing

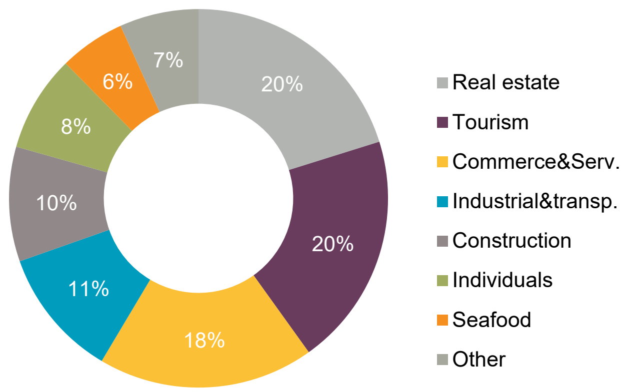
Additionally, cross-selling to other divisions within the Bank is an important role of Business Banking.

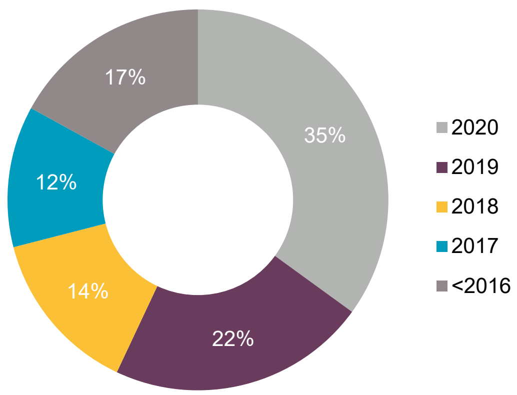
Loans

The Business Banking division offers loans that range from short- to long-term loans, asset-based financing and various other loan products.

The Business Banking division has grown its portfolio of loans to SMEs in recent years. Loans to SMEs increased from ISK 219,608 million as at 31 December 2018 to ISK 230,842 million as at 31 December 2019 and ISK 232,580 million as at 31 December 2020. As at 31 December 2020, 83% of the loan portfolio originated in the period from 1 January 2017 to 31 December 2020, and the loan portfolio was split geographically with 59% of the portfolio originating in the capital area and 41% originating in the rest of the country. As at 31 December 2020, 76% of the loan portfolio originated from the Bank's branches and 24% originated from Ergo.

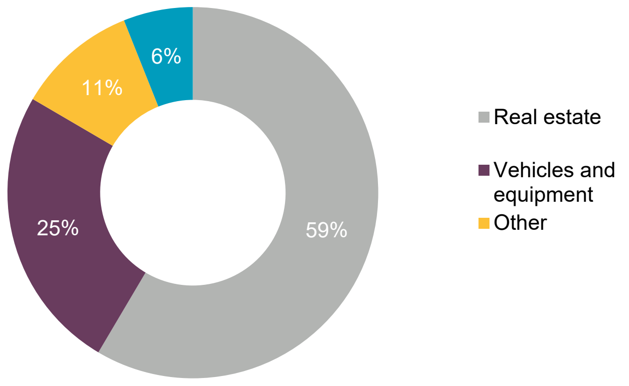
The graphs below set forth the distribution of loans of Business Banking by industry sector and origination year as at 31 December 2020:



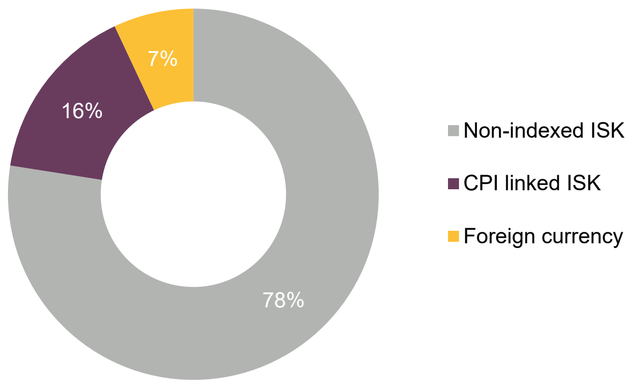


The Business Banking loan portfolio is well diversified, with no legacy problems. As at 31 December 2020, 11% of the Business Banking loan portfolio was subject to payment holidays, mainly isolated to the tourism sector. 70% fewer customers had payment holidays as at 31 December 2020 than in the first wave of COVID-19.

The graph below presents the collateral split of long-term loans in the Business Banking portfolio.



The graph below sets forth the currency composition of the loans to customers as a percentage of total loans to customers outstanding as at 31 December 2020.



Deposits

The Bank offers various saving options that suits the needs of the Business Banking customers, including regular savings accounts, on demand accounts, CPI-linked accounts, rates and foreign exchange accounts. In addition, the Bank offers fixed rate deposits where the funds are not accessible (locked) for a predetermined time which may vary from one to twelve months.

In November 2020, the Bank launched a digital onboarding solution that made it possible for customers to open a new saving and checking accounts in a few minutes online.

Historically, deposits from SMEs have been steady but increased significantly last year. The loan-to-deposit ratio was 123% as at 31 December 2020. Total deposits as at 31 December 2020 were ISK 190 billion, compared to 168 billion as at 31 December 2019.

Payment solutions

Customers of the Bank have access to simple and effective payment services. The Bank has an exclusive contract with MasterCard, which means that all debit cards, gift cards and credit cards issued by the Bank are MasterCard branded and can be used for payments worldwide. Since 2018 customers have been able to use touchless payments on Android phones and Apple Pay was added as a payment option for all cards in 2019. Wearables, such as Apple Watch, Garmin and Fitbit, can also be used for touchless payments. These modes of payment, often termed tokenised payments, are increasingly taking over from plastic cards especially due to COVID-19.

There are several types of payment solutions available through digital channels. Through the Bank's online bank and mobile app, Business Banking customers can transfer ISK funds between domestic accounts in real time. Through the online bank they can also issue SEPA and SWIFT payments to almost any accredited bank around the world. These payment solutions are available to Business Banking customers as batch payments in addition to single payments. In the last few years, more customers have started using open banking APIs to transfer funds, often in batch payments, via third parties like accounting software solutions.

Collection services

Payment requests can be issued to anyone with an Icelandic social security number. The payment request is sent to the online bank or mobile app of the payment request recipient. This is a very effective and efficient payment solution. In addition, the service provides the customer a good overview of its finance/status (e.g., overview of paid/unpaid accounts receivables, which is particularly beneficial to smaller businesses that do not have an accountant or accounting software).

Ergo

Ergo, the asset-based financing unit of Íslandsbanki, is a part of Business Banking and specialises in financing of motor vehicles, travel equipment and equipment and machineries for corporates and individuals. Ergo generated 18% of the Business Banking's income in 2020. With 35 years' experience in the asset leasing market, Ergo is determined to distinguish itself from its competitors by providing excellent, professional and rapid service to customers. Ergo's reputation as a market leader was further supported when Tesla selected Ergo as its official financing partner upon entering the Icelandic market in 2020. As at 31 December 2020, 24% of Business Banking loan portfolio originated from Ergo.

Supporting sustainability development, Ergo offers green financing, at favourable rates, encouraging the Bank's customers to accelerate energy exchange in cars and take advantage of the environmentally friendly options. Ergo was the first to offer loans for electric bicycles and charging stations. In the second half of 2020, 40% of financed new cars to individuals were green financing. Environmentally friendly cars in Ergo's individual loan portfolio amounted to 22% in 2020, as compared to 16% in 2019.

Digital solutions

The Bank has had digital solutions available for businesses since 2002. With changing customer demands, the Bank has put a larger emphasis on digital solutions. All corporate online banking users can access their daily business activities through the Bank's mobile app and customers are able to open accounts and credit cards via the Bank's website. In 2020, the Bank partnered with Payday, which offers financial solutions for small businesses, e.g., digital invoices. The Bank welcomed business users to the Bank's mobile app and recent and with constant improvements the corporate online bank was ranked as the best corporate online bank in 2020 in Iceland, according to a survey by Gallup. In 2020 the Bank also started offering digital signatures for various documents, serving customers while the branches were closed due to COVID-19. At year-end, the Bank introduced a new on boarding solution that allows new business customers to start business banking online and in the near future onboarding through app will also be an option, with automated lending through the app and online bank anticipated in the medium term. The Bank aims to continue improving customer experience in digital solutions while maintaining personal service.

Support to entrepreneurs

The Íslandsbanki Entrepreneurship Fund aims to encourage innovation and development and to support entrepreneurial projects that contribute to the four UN Sustainable Development Goals the Bank has decided to implement in its strategy: quality education, gender equality, climate action and innovation and infrastructure. The fund granted ISK 60.5 million to 27 innovation projects in 2020. As mentioned above, SMEs play a great role in the economy as important sources to investment, innovation, and inventions. The Chairman of the Board of the Entrepreneurship Fund is Una Steinsdóttir, Managing Director of Business Banking.

Operations and Distribution Capabilities

The Business Banking division generates operating income through the provision of financial products and services, on which the Bank earns interest income and fee and commission income. Operating income for the Business Banking division was ISK 12,503 million, ISK 12,553 million and ISK 11,306 million for the years ended 31 December 2020, 2019 and 2018, respectively. As at 31 December 2020, 2019 and 2018, the Business Banking division's customer loan portfolio amounted to ISK 232,580 million, ISK 230,842 million and ISK 219,608 million, respectively, and the total amount of deposits with the Business Banking division amounted to ISK 189,847 million, ISK 167,623 million and ISK 164,738 million, respectively.

The table below sets forth certain operational data for the Business Banking division as at 31 December 2020.

Market share of SMEs (*source :Gallup*)	35%
Total number of SMEs (including associations such as housing associations)	19,600
Total number of Ergo customers	10,100
Total number of the Bank's branches	12
Total loans outstanding	ISK 233 billion
Total deposits	ISK 190 billion

The table below sets forth certain operational data for the Business Banking division as at the dates and for the periods indicated.

	As at and for the year ended 31 December				
	2020	**% change**	**2019**	**% change**	**2018**
Number of active online banking users	11,500	1%	11,400	2%	11,200
Number of active Bank mobile app users	2,500		0		0
Number of interactions through ATMs	8,000	-55%	18,000	6%	17,000
Number of calls to the contact centre	40,000	9%	37,000	-17%	44,000

The table below sets forth the range of services available to the Business Banking division's customers through online banking, the Bank mobile app and ATMs.

Online Banking	**Bank Mobile App**	**ATMs**
Current accounts	Electronic overview	Deposits
Savings	Money transfer	Balance check
Loans	Domestic payments or transactions	Pin change
Money transfer	Retrieve pin	Withdrawals
Domestic and international payments or transactions	Overview of loans, deposits and credit cards	Unpaid bills
Batch payments	Unpaid bills / pay bills	
Financial overview, incl. loans, deposits, balance, etc.	Open new accounts	
Collection service	Electronic documents	
Unpaid bills	Freeze card	
Cash pooling	Balance check	
Access management		
Approval process		

<u>Branches and banking centres</u>

The Bank operates two Business Banking centres, one at its headquarters in Norðurturn/Kópavogur that services customers located in the greater capital area and one located in Akureyri that services customers located in the North and East Iceland. A contact centre is also located at headquarters, which provides service to Business Banking customers for the whole branch network. Business Banking operates in ten of the twelve strategically located branches, around the country to ensure that all Business Banking customers get the best service possible.

Despite decrease in overhead and number of branches service level has been preserved and the Business Banking centres allow all branches to draw from their combined experience. Additionally, customers increasingly sought assistance via the online and digital tools. 63% of customers use online banking as their primary channel for banking, with around 250,000 monthly visits, and 99% of all transactions happen online.

The Bank's branches offer access to self-service solutions and personalised advisory services provided by business managers and advisors.

<u>Credit culture</u>

The Business Banking division centres and branches have a strong credit culture, emphasising the ability to repay and cash flow above collateral. Credit decisions are decentralised with appropriate involvement of managers and credit committees. Employees of Business Banking have an average experience in the banking sector of over 20 years. Business Banking operates on a risk oriented and disciplined pricing models. Business Banking has its own risk policy with diversity thresholds specified.

At the Business Banking centre in Norðurturn/Kópavogur credit managers in the capital area were centralised in 2020 under the credit management headquarters department, with the objective to emphasise specialisation, increase analysis and provide support to the overall branch network.

Corporate & Investment Banking

Overview

The Corporate & Investment Banking division was formed in 2017 when the Bank's Capital Markets and Asset Management divisions were merged with the Corporate Banking division. The rationale for the merger was to create a division that could provide comprehensive services to large corporates and investors.

The Corporate & Investment Banking division provides comprehensive universal financial and investment banking services to large corporates, municipalities, institutional investors, and high net worth individuals. The Bank's experienced employees provide customised products and services to customers, including lending and advisory services, risk management products, securities and currency brokerage, asset management and private banking services. The Bank takes great pride in building and maintaining relationships across all industry divisions within Iceland. Outside Iceland, the Bank specialises in the North Atlantic fishing industry, drawing on its expertise in the domestic market and global contacts. The North Atlantic portfolio represents 7.7% of Corporate & Investment Banking's loan portfolio. Building on its extensive experience of complex, wide-ranging projects, the Bank has led many of the largest transformational endeavours in the Icelandic economy in recent years.

The Bank is one of three market makers in the foreign exchange market along with Arion Bank and Landsbankinn. The Bank is a leader in the foreign exchange market due to strong business relations with the export industries, including seafood and tourism.

The Securities Sales unit enjoys a strong position in the market and the Bank has been a market leader in the trading volume on the stock exchange across all asset classes in the past two years, with an 18.7% market share according to Nasdaq Iceland in 2020 and had the highest trading volume in listed bonds in 2020 and second-highest volume in equities in 2020.

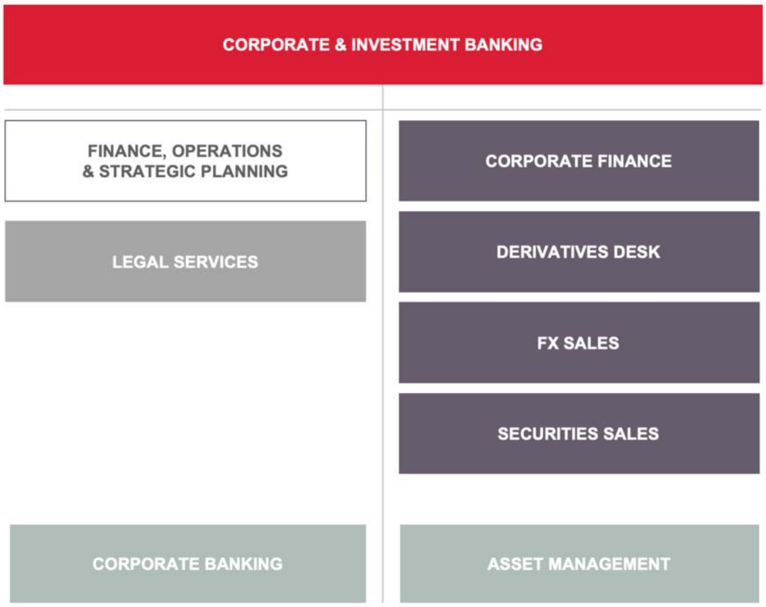
The Corporate Finance unit provides comprehensive investment banking advisory services to both companies and individuals, Corporate Finance has been considered a market leader in recent years, according to a Gallup survey among the executives of the country's 300 largest companies, with an overall market share in Iceland of 35%.

The Asset Management unit has offered asset management to institutional investors and high net worth individuals since 1986. The Asset Management division is one of the main distributors of Iceland Funds and has partnerships with two major global asset and fund managers, Vanguard and Storebrand. The growth in assets under management as at 31 March 2021 has increased by 47% since the beginning of 2019.

The Corporate & Investment Banking division focuses on efficient and direct communications, emphasising cooperation across the departments within the division, to meet its customers' needs as effectively as possible. The division focuses on multi-product customers and provides a full range of financial and investment banking services to its customer groups. The Bank focuses on maintaining long-term relationships with existing customers and attracting new customers with the aim of building new long-term relationships.

As at 31 December 2020, the Corporate & Investment Banking division had 68 full time employees in six business divisions and two support divisions, Legal Advisory and Finance, Operations and Strategic Planning. The employees within Corporate & Investment Banking have an average banking experience of 14 years.

Organisational structure



<u>Corporate Banking</u>

The Corporate Banking unit provides full range services with a focus on the largest 300 corporates in Iceland. Corporate Banking manages business relationships with these large corporates and large project specific transactions requiring more complex credit analysis and structuring. The unit is responsible for the Bank's complete product offering to these customers. It provides service to all sectors of the Icelandic economy although particular focus has historically been on the seafood, for which the Bank has a 32% market share of lending to the domestic seafood market amongst Icelandic banks, tourism, real estate and construction sectors.

A team of 10 experienced relationship managers, with an average banking experience of 18 years, are responsible for the customer relationships with the support from six credit managers. Each relationship manager is responsible for a specific customer portfolio, knowing their business, industries and their service requirements.

Corporate Banking operates a relationship-based service model with a focus on proactive sales and a multi-product approach addressing each customer's financial needs. The direct relationship of a relationship manager with each customer is an important factor in providing proactive and tailored service to the customer base.

Corporate Banking generates operating income through the provision of credit products, deposits and other corporate services, on which Corporate Banking earns interest income and fee and commission income.

The Corporate Banking team has a proactive sales approach. Therefore, over the past few years it has been active in setting goals relating to seeking to meet with current and future potential customers. Despite cyclicality in the domestic economy, experience has shown that aggressive goals in this area translate to increased business, not only lending, but also opportunities relating to other divisions of Corporate & Investment Banking.

Over the years, Corporate Banking has consistently and successfully delivered solutions to its customers' complex financial needs; whether by acting as a lead arranger in large syndicated loan transactions with foreign and/or domestic banks, participating in club transactions with fewer banks, bilateral lending agreements or utilising the Bank's Securities Sales to raise capital from the domestic bond or equity market.

Outside of Iceland the unit is responsible for the Bank's North Atlantic strategy which was originally approved by the Íslandsbanki Board of Directors in 2013 and reaffirmed in 2018. The strategy was intended to build up the Bank's international lending business by leveraging the Bank's traditional strength in the seafood industry. The strategy was intended to provide an additional channel for growth, reduce risk by diversifying the portfolio and provide attractive risk-adjusted returns. The Bank and its predecessors have been doing business in North America for more than 20 years and the Bank has developed strong relationships with many of the leading seafood companies in the region, which form the foundation for the strategy.

The international strategy has been successful. New lending has grown in line with plan, and the average margin on the international portfolio is above the margin for Corporate Banking as a whole. Although the international portfolio is smaller than expected, due in part to turnover in the portfolio, it accounts for a significant portion of the Bank's seafood portfolio, providing meaningful diversification. As at 31 December 2020, total revenue and profitability related to the North Atlantic strategy were above the Bank's original projections due to a combination of attractive interest margins and associated fees.

Foreign Exchange Sales

The Foreign Exchange Sales desk provides services related to foreign exchange and interest rate products. All customers' spot trades are conducted via the Foreign Exchange Sales desk. The Foreign Exchange Sales team is in direct contact with institutional investors, pension funds, large corporate customers and others trading sizeable amounts. Foreign Exchange Sales is also responsible for pricing cross currency rates in online banking and other systems used for spot execution for individuals, SMEs, etc. Foreign Exchange Sales works closely with customers in need of hedging currency and interest rate risk.

The experience and knowledge within the Foreign Exchange Sales team is high, with an average of 13 years of banking experience.

Derivatives Desk

The Derivatives Desk provides risk management products and market making services in cooperation with Foreign Exchange Sales and other divisions. The Bank is one of three market makers in the foreign exchange market, along with Arion Bank and Landsbankinn. The average experience of the employees on the Derivatives Desk is 18 years.

Securities Sales

The Securities Sales unit offers professional investors access to equity and bond markets and investments in derivatives, including forward contracts in stock and bond markets. The unit participates in share buybacks for listed companies and has managed issues of bonds both issued by the Bank, specifically the Bank's covered bonds, and primary issues for third parties. The Bank ranked number one in trading volume across all asset classes in 2020 and 2019, number one and two in listed bonds in 2020 and 2019, respectively, and number two in equities in both years.

The brokerage desk is staffed by people with extensive experience in both the equity and bond markets, with employees having an average 10 years of experience.

Corporate Finance

The Corporate Finance team is composed of a highly experienced team with extensive knowledge of the Icelandic financial market. The unit is one of the largest and most experienced Corporate Finance teams in Iceland, with the capacity to undertake large projects and see them through successfully. Corporate Finance enjoys the support of other units within Corporate & Investment Banking, such as investor relations through strong activities in the field of asset management and securities brokerage.

Since 2015, the Corporate Finance team has completed 50 transactions relating to acquisitions, sales and share offerings, both domestically and abroad. The transaction amount of these projects amounted to a total of ISK 217 billion. The team is recognised as a leader in initial public offerings, having managed or co-managed 50% of IPOs on the Nasdaq Iceland main market during the period 2010-2020, in addition to overseeing two of the four takeover bids that have been made on the main market in recent years.

Asset Management

Asset Management is split into units: Private Banking, Institutional Investors and Asset Servicing. The Bank's Private Banking and Institutional Investors units offer discretionary asset management and advisory services for large investors i.e. pension funds, high net worth individuals, investment companies, funds, and charities. Asset Servicing provides services to large institutions such as pension funds and private equity funds.

Asset Management generates operating income through interest income and management fees, which is calculated as a percentage of assets under management. The Asset Management unit has a long-term track record in providing high quality service and returns on investments to its 1,300 customers, 200 institutional customers and 1,100 high net worth customers. The employees' average experience is 26 years.

Strategic priorities

The Corporate & Investment Banking division has a clear strategy for maintaining its position in the market by offering the best in class products and services while focusing on business relations and the importance of knowing the Bank's customers' business and executing proactive service strategy. Continuing its multi-product customer focus and leverage existing relationships with large corporate customers to promote their tailored product and service offerings.

The division is committed to retaining its position as the leading investment bank in Iceland with the leading position in Corporate Finance and Foreign Exchange Sales, as well as leading the trading volume across all asset classes on Nasdaq Iceland.

The Corporate & Investment Banking division is focused on its return on equity by disciplined pricing and efficient use of capital, with emphasis on fee generating projects and less capital-intensive lending products. This strategy is supported by strong credit culture and clearly defined risk appetite, building on a robust and diversified loan portfolio with the largest customers.

The Bank is continuously focused on increasing efficiency to enable more throughput at a stable cost. Digital solutions have been implemented and will be developed to increase efficiency and improve customer experience, for example, through onboarding of new customers. The Bank will continue to digitise areas that improve customer experience while maintaining personal service through the relationship management model.

The Corporate & Investment Banking division aims to launch new sustainability products, including green construction loans and blue loans. The Bank has set ambitious targets to increase sustainable loans in the portfolio and tracks the share of sustainable lending against total lending. The division is also striving to maintain gender equality within the division and to work towards the Bank's goals in gender equality. In addition, the division has conducted an ESG risk assessment on 24 of its largest credit exposures and is currently incorporating the learnings from that process into its key lending, investment, and product processes.

Customers

Corporate & Investment Banking provides a full range of financial and investment banking services to large companies, municipalities, institutional investors, and high net worth individuals.

The Corporate & Investment Banking division has a broad range of customers with long-lasting relationships. The customer base can be split into three categories: corporates, institutional investors and individuals. As at 31 December 2020, the estimated number of active customers were 350 corporates, 200 institutional investors and 1,100 private banking customers. Customer service is the core of the Corporate & Investment Banking culture, and the Bank has delivered a best in class net promoter score for the last eight years.

Products and Services

The table below sets forth the financial products and services offered by the Corporate and Investment Banking division.

Loans	**Deposits**	**Foreign exchange**	**Securities sales**	**Corporate finance**	**Asset management**
Term loans	On demand and term deposits	Foreign exchange spot	Equity spot trade	M&A	Discretionary asset management
Revolving credit facilities	Money market deposits	Foreign exchange forward	Bond spot trade	Equity issuing, including IPO and public listings	Advisory
Construction loans		Foreign exchange swaps	Bond and equity forwards	Bond issuing and public listings	Asset servicing
Overdraft facilities		Interest rate swaps	Bond primary issues for the Bank and third parties	Valuation, restructuring and other related services	
Guarantees		Cross-currency interest rate swaps	Shares buybacks		

Loans	Deposits	Foreign exchange	Securities sales	Corporate finance	Asset management
		Foreign exchange options			

Corporate & Investment Banking also offers its customers day-to-day banking services via the Business Banking branch network.

Loans to customers

Corporate Banking offers loans that range from short- to long-term loans, revolvers, and construction finance to operating companies usually backed by collateral in fixed or floating assets. Corporate Banking has a very strong credit culture and has defined its own risk policy. Loans to corporate customers drive the operating income of the Corporate & Investment Banking division.

Corporate & Investment Banking's loan portfolio has increased over the last three years and totals ISK 353,953 million as at 31 December 2020. The loan portfolio is 46% denominated in foreign currencies (foreign exchange), 41% denominated in non-indexed-linked (NIL) ISK and 13% denominated in indexed-linked (CPI) ISK.

The table below sets forth the components of the loans to customers as a percentage of total loans to customers outstanding as at the end of each year indicated.

	2020	2019	2018
Loan portfolio amounts (ISK millions)	353,953	334,788	322,974
Foreign exchange	46%	43%	43%
Non-index linked (NIL)	41%	40%	37%
Consumer price index-lined (CPI)	13%	17%	20%
Total	100%	100%	100%

The split between different instruments or products is set out in the table below.

	2020	2019	2018
Term loans	88%	84%	83%
Revolving credit facilities	3%	4%	6%
Construction facilities	6%	9%	7%
Overdraft facilities	3%	4%	4%
Total	100%	100%	100%

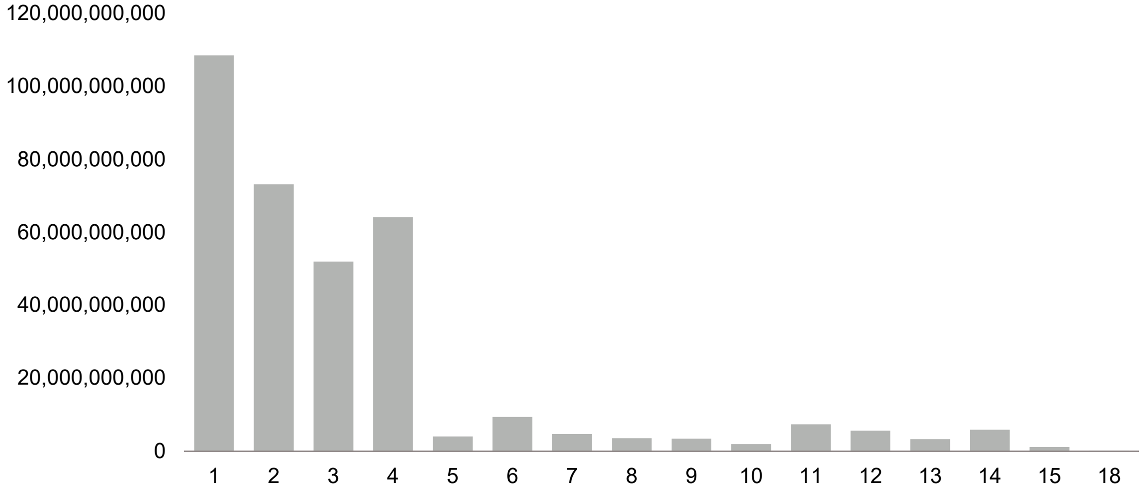
In addition to the products listed in the table above, Corporate & Investment Banking has off-balance sheet items, such as guarantees and undrawn facilities. The total amount is ISK 62,023 million, ISK 54,394 million and ISK 55,535 million for the years ended 31 December 2020, 2019 and 2018, respectively. The split is set out in the table below.

	2020	2019	2018
Guarantees	18%	7%	7%
Undrawn facilities	82%	93%	93%
Total off-balance sheet items	100%	100%	100%

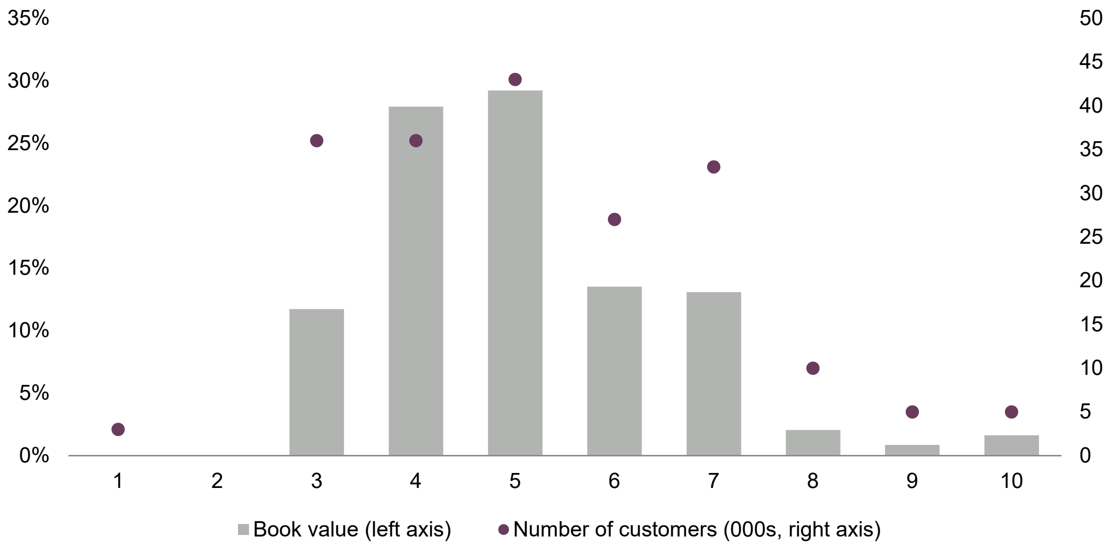
The Corporate & Investment Banking loan portfolio is diversified by various measures, including by sector. The split is set out in the table below.

	2020	2019	2018
Seafood	31%	28%	29%
Real estate	25%	25%	26%
Tourism	13%	14%	16%
Commerce & Services	9%	8%	8%
Industrials & Transportation	8%	10%	9%
Construction	5%	7%	3%
Investment companies	5%	5%	5%
Other	3%	4%	4%
Total	100%	100%	100%

The average maturity profile of the loan portfolio is 3.3 years. The graph below shows the loan portfolio (in ISK) split by final maturity (in years) as at 31 December 2020.



The graph below shows the distribution of the loan portfolio by risk class as at 31 December 2020. The dots represent the number of customers in each category. Around 2% of the loan portfolio is categorised in risk class 10. However, the default rate as at 31 December 2020 was only 0.004%, with one customer having loans in arrears.

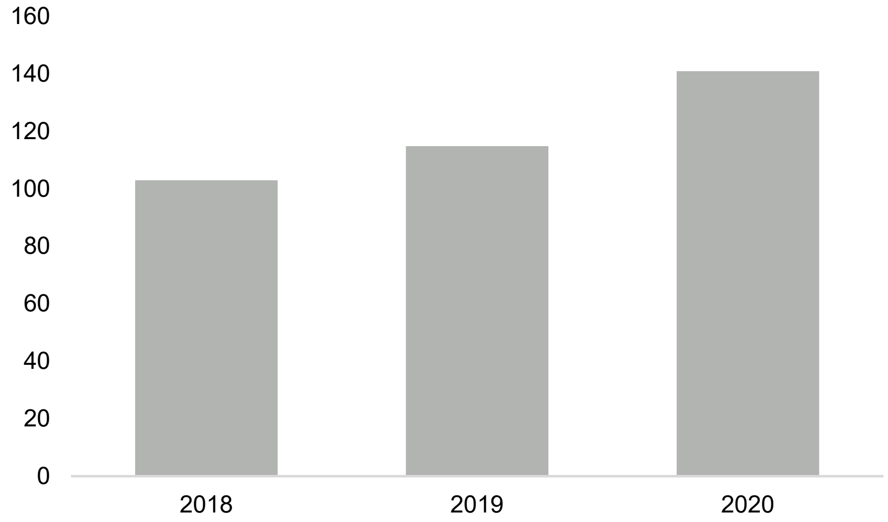


The weighted average risk class has increased from 4.96 in 2018 to 5.06 in 2020, mainly due to the downturn in the economy as a result of COVID-19.

Deposits

This division offers various saving options for large companies and institutional investors. The saving options are in various forms of deposits, both traditional and money market (i.e. on demand, CPI-linked and term deposits). Most products are available in ISK Króna and foreign currency.

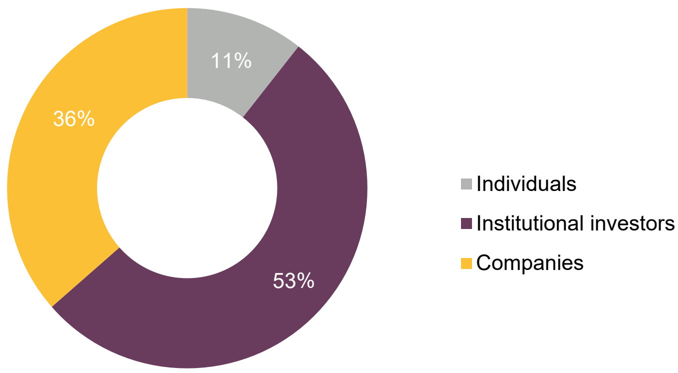
The chart below shows the growth of deposits (ISK in billions) in the division for the past three years.



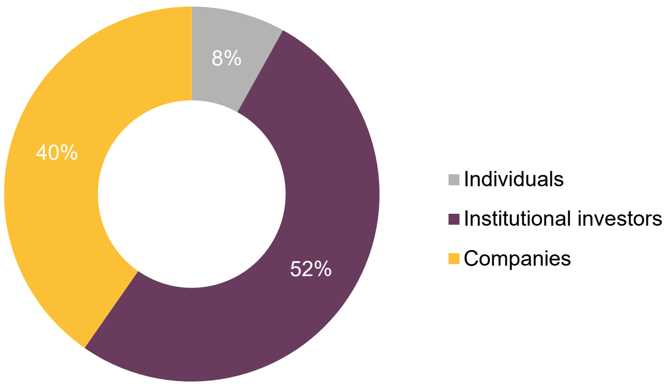
In 2020, deposits from companies increased 12.6% and 28.1% from institutional investors compared to 23.4% and 8.8%, respectively, in 2019. Deposits from individuals remained relatively stable from 2018 to 2020. The increase in deposits from institutional investors can be attributed to the lack of investment opportunities domestically and abroad. Increased cash inflow into the pension funds due to individuals refinancing their mortgages has also led to an increase in deposits in the division.

The graphs below set out the split of deposits per customer type in 2018, 2019 and 2020.

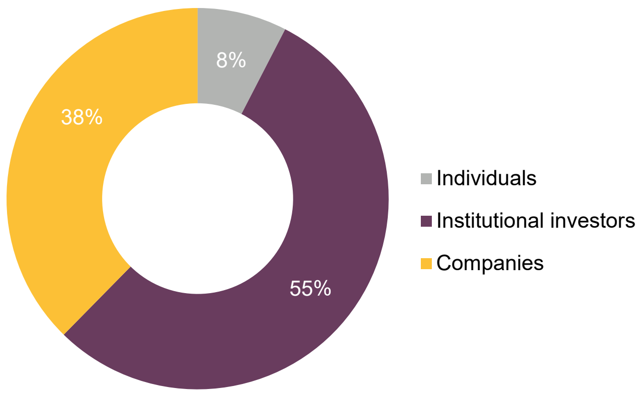
2018



2019



2020



<u>Foreign Exchange</u>

The Foreign Exchange Sales desk provides service related to foreign exchange and interest rate products. Besides working on day-by-day spot trading, an important part of the entity's service is working with customers in need for hedging currency and interest rate risk. Unlike spot trading, hedging products have future cash flow or commitments to minimise risk in customers' business. Hedging is conducted with derivatives trading products and are at the same time an add-on service to customers that generates higher revenue for the Bank.

Hedging contracts are thoroughly monitored within the Bank, and the Bank maintains necessary collateral for each contract. Forward, swap and option contracts have a maximum duration of one year, but interest rate swaps and cross-currency interest rate swaps usually have a final maturity minimum of at least two years.

<u>Derivatives Desk</u>

The Derivatives Desk supports Foreign Exchange Sales and other divisions with market making and trading in currencies and risk management products such as IRS, CIRS and Foreign Exchange Options and manages the risk for the Bank in those products. The Derivatives Desk is one of three market makers in the ISK against other currencies and provides execution to domestic and foreign banks and manages the Bank's currency exposure.

<u>Securities Sales</u>

The Securities Sales offers professional investors access to share and bond markets and investments in derivatives, including forward contracts in stock and bond markets as listed in the table above. It participates in share buybacks for listed companies and has managed issues of bonds both issued by the Bank (specially the Bank's covered bonds) and primary issues for third parties.

Besides offering standard spot trading access to its customers for both equity and bonds, the Bank also offers forward contracts. The forward contracts are an important generating division and also support the revenue generating capability of the spot trade section.

The forward contracts are thoroughly monitored within the Bank, both in terms of the duration of each contract and to the allowable size of each forward portfolio. The term of the contracts is limited, and the margin requirements are constantly monitored.

Forward contracts are offered to customers for all the listed equity on the main market of the Icelandic Stock Exchange. The spectrum on bonds offered on forward contracts is somewhat limited, although it fully covers the most traded bonds. Bonds that are listed, but lack turnover in the secondary market, are excluded.

Corporate Finance

Corporate Finance provides comprehensive investment banking advisory services to both companies and individuals, such as the acquisition and disposition of company shares, mergers and other changes in ownership structure. Furthermore, the unit provides advisory services in connection with public listings including the management of share offerings, the preparation of prospectus, and the admission of securities to trading on the exchange. Corporate Finance also assists companies in obtaining debt funding, whether through banks or through the issuance and sale of bonds to investors.

Asset Management

The Asset Management unit provides a full range of asset management products and services in cooperation with the Bank's subsidiary, Iceland Funds. Customers are institutional investors, such as pension funds and institutions and high net worth individuals. Asset Management is dedicated to building long-term relationships with its customers, and the average relationship is 16 years.

The Bank manages assets in a broad range of asset classes. Customers are provided investment policies according to the risk profile of each customer. The Bank's background in Asset Management has been conservative, and the focus is on long-term yield.

The Asset Management division provides discretionary asset management and advisory services. As at 31 December 2020, assets under management were 75% in discretionary services and the remaining 25% in advisory services.

The Asset Management division provides advanced services, such as a back office and a reporting tool for pension funds, to institutional investors and private equity funds. The customers have direct access to their portfolios and can view them directly in the Banks security system.

Operations and Commercial Capabilities

Operating income for the Corporate & Investment Banking division was ISK 13,527 million, ISK 12,491 million and ISK 11,350 million for the years ended 31 December 2020, 2019 and 2018, respectively. As at 31 December 2020, net interest income represented 63% of operating income, and fee and commission income represented 30% of operating income.

As at 31 December 2020, 2019 and 2018, the Corporate & Investment Banking division's loan portfolio amounted to ISK 353,953 million, ISK 334,788 million and ISK 322,974 million, respectively. The deposit portfolio was ISK 141,070 million, ISK 113,455 million and ISK 101,417 million, respectively.

The table below sets forth certain operational data for the Corporate & Investment Banking division as at 31 December 2020:

Market share among 300 largest corporates in Iceland (based on Gallup survey in Q4 2020 among the 300 largest companies in Iceland, from the question "*Which is your main bank?*") ...	35%
Number of large customers serviced from the Corporate & Investment Banking division	Approximately 350
Number of private investors and institutions serviced from the Asset Management division	Approximately 200 institutional investors and 1,100 private banking customers
Number of employees	68
Total loans outstanding to Corporate Banking customers	ISK 353,953 million
Deposits..........	ISK 141,070 million

Assets under management	ISK 141,638 million
Net fee and commission income and other income	ISK 4,997 million
Market share in trading volume of listed equities on Nasdaq Iceland	18.2%
Market share in turnover in listed bonds on Nasdaq Iceland	19.0%
Market share in trading volume across asset classes on Nasdaq Iceland	18.7%
Number of initial public offerings since 2010	Managed or co-managed 8 of 16 IPOs

Other Divisions and Subsidiaries

Subsidiaries

The Bank's significant subsidiaries are Íslandssjóðir hf. (Iceland Funds) and Allianz Ísland hf. In addition, the Bank has control over 10 other non-significant subsidiaries.

Íslandssjóðir hf. (Iceland Funds)

Overview

Iceland Funds is the oldest and largest fund management company in Iceland, established in 1994. Iceland Funds is a wholly owned subsidiary of the Bank and leverages the Bank's distribution network through private banking, retail banking and online banking. Iceland Funds has a market share of over 34% as at 31 December 2020 in the domestic mutual fund market compared to 23% market share as at 31 December 2016 (*source: keldan.is*). This increase is primarily due to the consistent top performance of most of the funds managed by Iceland Funds, which has resulted in a steady onboarding of new customers and inflow of assets. The long-term average market share is expected to be approximately 30%. Iceland Funds is the market leader in fixed income and its market share in equities has increased by 50% in the last five years to 2020.

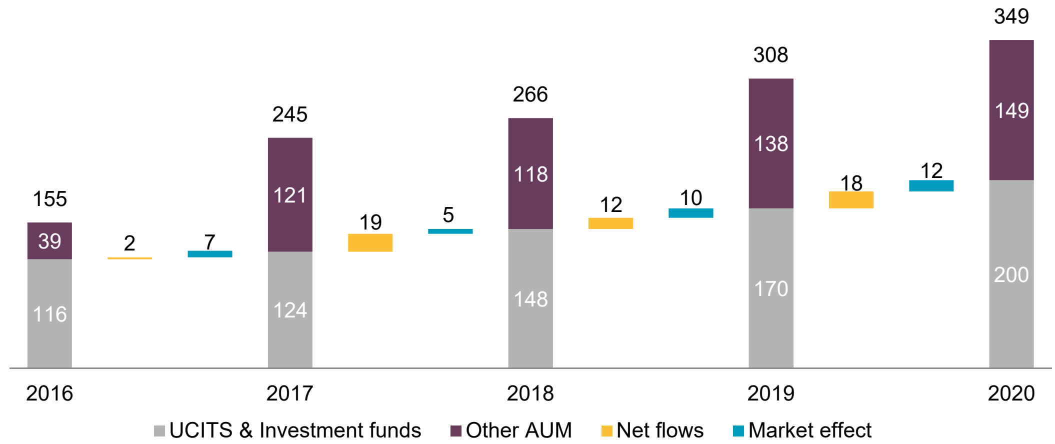
Iceland Funds has become the largest player in the individual market, and its biggest competitors are Landsbréf and Stefnir, along with smaller fund management companies, such as Kvika eignastýring, Akta and Íslensk Verðbréf. Total assets under management, including discretionary asset management and alternative investments, were ISK 349 billion in 2020 with a revenue of ISK 1,846 million.

Iceland Funds' cost base is mostly fixed, consisting primarily of salary cost and service fees paid to the Bank, which amounts to ISK 615 million annually and is generally one-third of revenues. Iceland Funds' fee and commission income consists of 80% of fund management fees that are stable and grow in line with assets under management. The main growth drivers will be access to new customers through digitisation and innovative product development in line with current trends in the market.

The table below sets forth the assets under management of Iceland Funds as at the dates indicated.

	As at 31 December		
	2018	**2019**	**2020**
		ISK in billions	
Mutual funds	200	170	148
Alternative funds	14	14	16
Asset management	135	124	102
Total	349	308	266

The graph below presents the development of assets under management since 2016, indicating net flows and market effects relating to UCITS & Investment funds (ISK in billions).



Organisational structure

Iceland Funds manages 22 mutual and investment funds, as well as alternative investment funds, Akur Private Equity Fund, Alpha Equity Fund, FAST-3, 105 Miðborg and Commodity Strategy Fund. Furthermore, Iceland Funds has risk management, business development, operations and in-house legal advisory.

Business performance is driven through a highly skilled and experienced team of 21 investment professionals, with extensive experience in fund management and financial markets. The team has over 17 years of experience on average, and employee turnover has historically been low.

Iceland Funds has its own risk management division, which is responsible for the daily monitoring of fund investments, both according to investment strategy and applicable legal requirements, as well as daily monitoring of portfolios managed by the discretionary asset management team.

While COVID-19 brought uncertainty to the market, Iceland Funds experienced a mostly positive impact from the pandemic. Higher levels of savings and low interest rates have led to an interest in higher risk products, such as equity funds and balanced asset allocation funds.

Fund Management Services

Iceland Funds' managers oversee funds that invest in bonds, stocks and other financial instruments. Iceland Funds is a market leader in fixed income funds and has a quality customer base of 11,700 investors with strong customer retention. Iceland Funds' 10 domestic bond funds invest primarily in bonds denominated in ISK. They can be either indexed or non-indexed bonds and with or without a government guarantee. The four equity funds invest primarily in domestic-based stocks aside from one fund that invests in other equity funds that invest in companies listed on global stock markets. The remaining eight mixed funds invest in a variety of different bonds, stocks and securities, where risk is divided between various assets. The customer segmentation of Iceland Funds' assets under management consists of 50% individuals and 50% legal entities, but, more specifically 67% retail customers and 33% professional.

Success in asset management requires a good track record and long-term performance. The Iceland Funds mutual funds team has historically been among the top performers, across different asset classes (*source: keldan.is*).

The graph below shows 10 years of annualised returns for the three active equity funds in Iceland with 10 or more years of activity, as well as recent Iceland Funds' performance achievements across different asset classes (*source: keldan.is*).

Recent Iceland Funds performance achievements

Fixed income funds (41 in total)
- #2 in Iceland in 2020 (IS CBI Fund)
- #1 in Iceland in 2019 (IS Non-Index Fund)

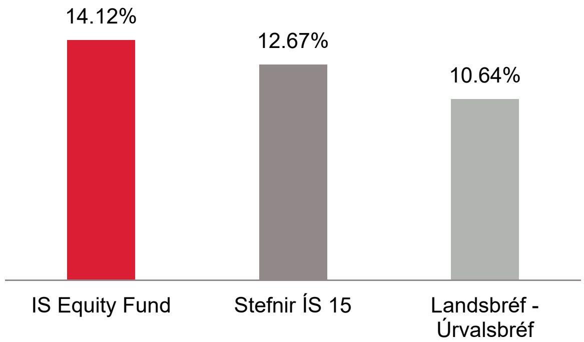
- #2 in Iceland in 2018 (IS CBI Fund)

Equity funds (13 in total)

- #2 in Iceland in 2020 (IS EQUUS)
- #1 in Iceland in 2019 (IS EQUUS)
- #2 in Iceland in 2017 (IS Equity Fund)

Technical asset allocation funds (34 in total)

- #1 in Iceland in 2020 (IS Einkasafn E)
- #1 in Iceland in 2019 (IS Einkasafn erlent)
- #2 in Iceland in 2018 (IS Einkasafn A)

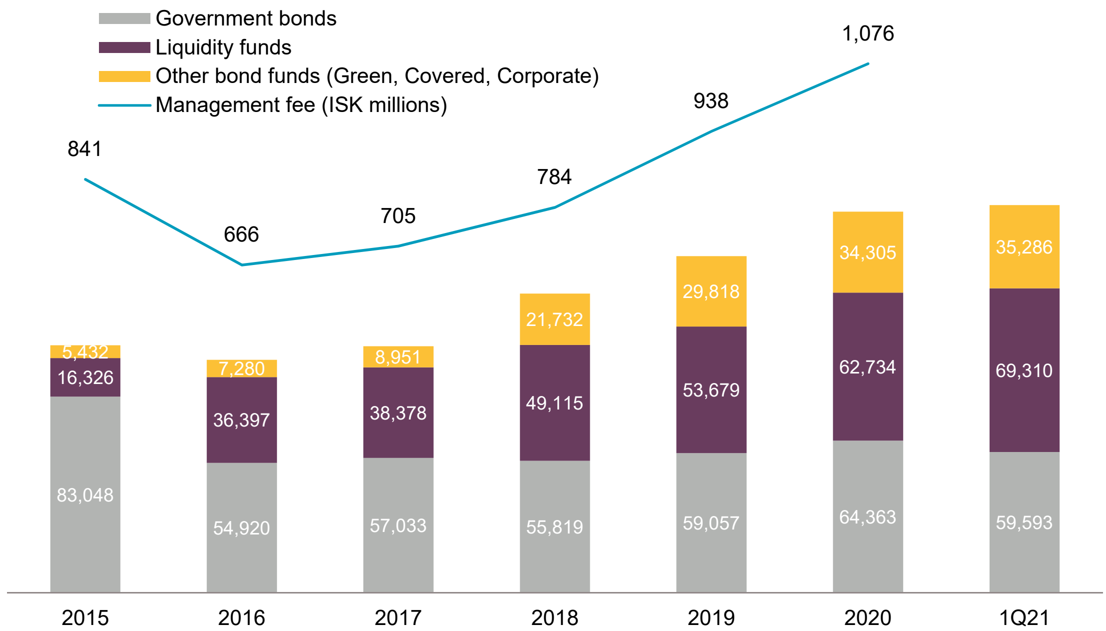


Iceland Funds is focused on offering the right solutions through product and business development. In 2015, the team identified a need in the market for covered bond funds, which today amounts to an ISK 25 billion portfolio. In 2018, Iceland Funds set up the first green bond fund in Iceland, IS Green Bonds, as there was a growing interest from both institutional and retail investors to invest responsibly. Young investors have shown a special interest in the product and the measurable impact their investment in the fund is having on the environment, which can be seen through the IS Green Bonds Impact Report found on Iceland Funds' website.

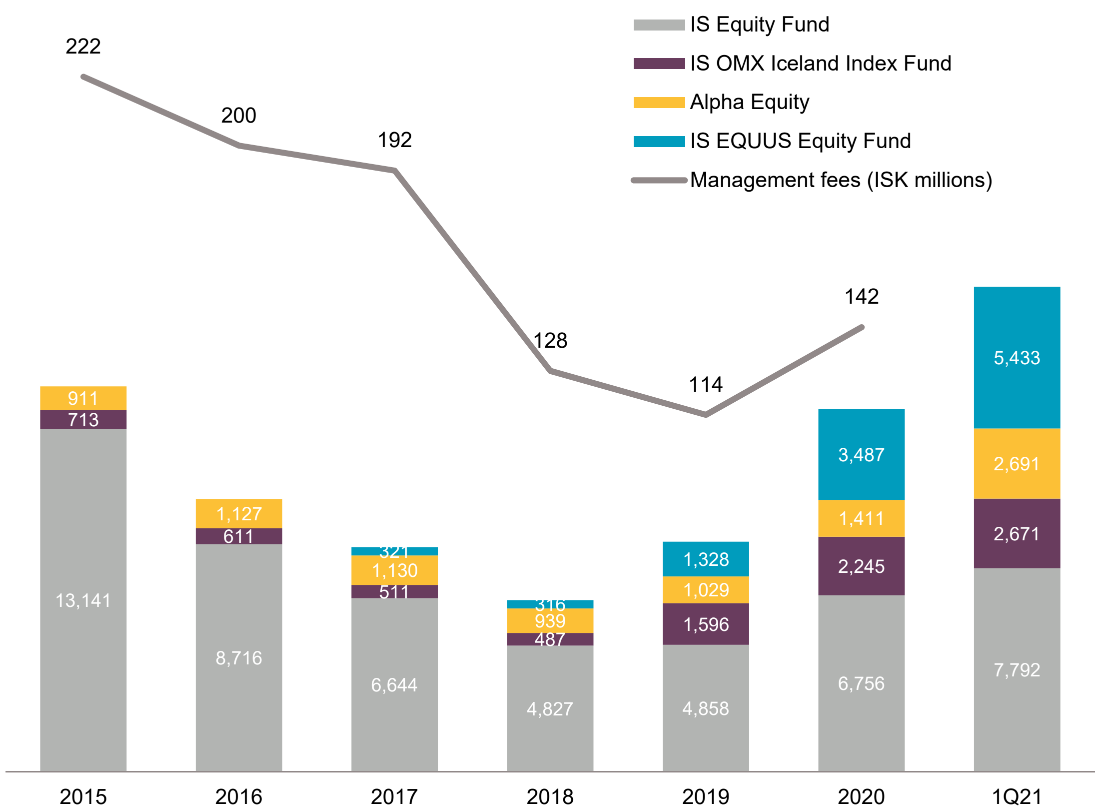
A main focus of Iceland Funds has been to diversify its income stream from government bonds to higher margin funds, such as equity funds.

As the graphs below illustrate, Iceland Funds has managed to diversify its income base substantially and as at 31 December 2020, 40% of its revenue was generated by products that Iceland Funds did not offer six years ago, such as covered bond funds, innovative equity funds and mixed funds.

The graphs below set out assets under management (ISK in millions) of Iceland Funds and the related management fee as at and for the periods indicated, respectively.



In respect of assets under management in 2020, Iceland Funds achieved management fee margins of 85 basis points in respect of government bonds, 35 basis points in respect of liquidity funds, and 95 basis points in respect of other bond funds (green, covered and corporate).



In respect of assets under management in 2020, Iceland Funds achieved management fee margins of 170 basis points in respect of IS Equity Fund, 40 basis points in respect of IS OMX Iceland Index Fund, 150 basis points in respect of Alpha Equity, and 185 basis points in respect of IS EQUUS Equity Fund.

Discretionary Asset Management

Iceland Funds' strong Discretionary Asset Management team manages assets for individuals, public entities and institutional investors that have made asset management agreements with the Bank.

The team consists of portfolio managers with an average of over 20 years of experience in the field. Over the years, the team has developed a clear investment process based on fundamental analyses in both domestic and international markets. When it comes to international markets, the discretionary asset manager is independent in its fund selection. The investment process for global equity funds is based on a proprietary investment process focussed on long-term risk adjusted returns.

The team has implemented responsible investing in all investment processes. The approach consists of both engagement and exclusion. The exclusion/observation list is updated twice a year and published on Iceland Funds' website.

The team works closely with the relationship managers at the Bank to service the customers and to build up a long-term relationships and trust.

Alternative Investment Funds

Since 2013, Iceland Funds has accumulated substantial experience in real estate investments and property development, as well as venture capital investments. An experienced team of seven experts manages Iceland Funds' alternative investment funds: Akur Private Equity Fund, Alpha Equity Fund, FAST-3, 105 Miðborg and Commodity Strategy Fund.

Responsible investment policy

Iceland Funds adheres to the principles of responsible investment in all asset management, and, in 2018, it established IS Green Bonds, the first green bond fund in Iceland. Since its inception, IS Green Bonds has yielded annual returns of 5.7% and had ISK 3.8 billion of assets as at 1 January 2021, representing 63% growth since the inception of the fund, with 98% retail investors.

Iceland Funds is a founding member of the forum "Iceland SIF", which was established in November 2017. The aim of the forum is to promote awareness and debate about the methods of sustainable and responsible investment. In addition to this, since 2013, the Icelandic Centre for Corporate Governance has recognised Iceland Funds as a model company with good corporate governance.

Both the employees and management of Iceland Funds place a strong emphasis on considering good corporate governance, as well as environmental and social issues in the investments carried out by the company. Iceland Funds' primary obligation is to guarantee its customers good, long-term returns and the board of directors of Iceland Funds believes that a clear, responsible investment policy tallies with that objective.

Iceland Funds published its first yearly ESG report for its operations in 2019.

Allianz Ísland hf. (Allianz Insurance)

Allianz Insurance is a wholly owned subsidiary of the Bank. Allianz Insurance sells personal insurance, i.e. life and pension insurance, accident insurance and health and sickness insurance through Allianz Lebensversicherung AG and Allianz Versicherung AG. Both Allianz Lebensversicherung AG and Allianz Versicherung AG have operating licences in Iceland according to Act no 56/2021 on insurance companies.

Other Divisions

The Bank has two support divisions.

Treasury and Proprietary Trading

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business divisions sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book. Treasury and Proprietary Trading had 7 employees as at 31 December 2020.

Cost centres

CEO Office

CEO Office consists of Human Resources, Marketing and Communications, Strategy, and Legal. The CEO Office had 52 employees as at 31 December 2020

Finance & operations

Finance includes financial reporting, back office and business analytics. Also included in Finance are Treasury and Proprietary Trading. Finance manages and oversees shareholding in the Bank's subsidiaries. Finance had 153 employees as at 31 December 2020.

IT

IT is responsible for the Bank's IT platform, systems and software development, including online banking, websites and its hardware, such as data centres, telephone systems, ATMs and personal computers. IT had 133 employees as at 31 December 2020.

Risk Management

The Bank has an independent risk management function, Risk Management, headed by the Chief Risk Officer. Risk Management is responsible for ensuring efficient implementation of the Bank's risk strategy and policies, for verifying that the Bank has efficient risk management processes in place and that each key risk that the Bank faces is identified and properly managed by the relevant function. Risk Management had 25 employees as at 31 December 2020. For information on the activities of the Risk Management, see "*Risk Management.*"

Internal Audit

Group Internal Audit is an independent function headed by the Chief Audit Executive and is responsible for assessing whether the Group's risk management, internal control framework (including internal policies) and governance processes are effective and efficient and whether they comply with the relevant legal and regulatory requirements. Group Internal Audit is not responsible for internal control or its implementation but provides the Group with independent, objective assurance and consulting services designed to add value and improve the Group's operations.

The work of Group Internal Audit is performed in accordance with a risk-based audit plan approved by the Board's Audit Committee. Group Internal Audit is furthermore responsible for internal investigations on suspected fraudulent activities. Group Internal Audit reports directly to the Board on its findings and suggestions for material improvements to the risk management, controls and governance processes. All audit recommendations are subject to a formal follow-up procedure by the appropriate levels of management to ensure and report their resolution.

The Chief Audit Executive is appointed by the Board and reports directly to the Board. Group Internal Audit operates independently from other departments in accordance with Article 16 of the Financial Undertakings Act. The responsibilities and authorisations of the Chief Audit Executive and Group Internal Audit are further outlined in the Group Internal Audit Charter.

Disposals

The Bank disposed of its 63.47% interest in Borgun hf. ("**Borgun**"), the payment acquirer and issuing processor, in July 2020. Prior to that, Borgun had been classified for the purposes of the Bank's consolidated financial statements as a disposal group held for sale and as discontinued operations.

Compliance

The Bank has an independent compliance function headed by the Compliance Officer. Compliance is specifically responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures, including new products and new services, concerning securities transactions and anti-money laundering in accordance with the AML Act, FATCA and the OECD CRS. Other compliance risk control processes and monitoring are managed and performed within the Risk Management subdivision as part of the operational risk management framework.

The Bank's Compliance Officer is hired by the CEO, subject to Board confirmation, conferring the department's mandate.

Information Technology

The Bank's IT division is responsible for developing, operating and advising on its technology and communication systems and solutions, including digital banking, internally developed and third-party software, and hardware such as data centres, telephones, ATMs and personal computers.

The IT division had 133 employees as at 31 December 2020 consisting of six product teams comprised of IT and business specialists, along with supporting functions such as enterprise architecture, platforms, and business management and operations.

The reliability of the IT and communications systems is a key factor in the Bank's activities as a financial enterprise. The Bank's IT infrastructure is comprised of two data centres in two locations in Iceland (one owned by Reiknistofa bankanna and the other owned by Verne). All IT hardware is owned by the Bank, and approximately 98% of the servers are virtual, with a physical backup located in both data centres and in a third location for disaster recovery. The IT system serves all branches of the Bank.

The IT division maintains relationships with a wide range of blue-chip suppliers, including Microsoft, SAP, Swift, Reuters and Bloomberg. In addition, the IT division has substantial in-house expertise, which allows for the development and integration of software internally.

Strong Technical Infrastructure

The Bank has invested in its technical infrastructure in recent years, creating a modern, innovative, highly scalable and cost-efficient bank. The Bank has:

- migrated to a global standardised core banking system (SOPRA) for payments and deposits;
- implemented a modern cloud and on-premises infrastructure, ensuring flexibility and scalability;
- implemented a standardised API platform integrated with a world-class identity/user management solution in support of a focused open banking strategy; and
- initiated the consolidation of the loan system environment in support of the automated loan application processes.

Furthermore, the Bank has placed an emphasis on the automisation of internal development processes and on software quality in order to respond efficiently to the rapidly changing technology landscape. This work has shortened delivery times and enhanced operational security, whilst at the same time achieving increased cost efficiency and stability.

This streamlined infrastructure enables the Bank to place an even stronger emphasis on developing new solutions for its customers.

Digital Strategy

In 2020, the Bank formulated a digital strategy that functions as the guidepost for digital product development and implementation of technology innovations. The strategy is based on five main pillars:

- Service first for customers and partners – delivering technical services (APIs) that will not only provide value-added capabilities to customers but also enable efficient partnering;
- Frictionless value chains – ensuring that digital processes provide end-to-end automation to ensure customer satisfaction and internal cost efficiencies;
- Relevant data and insights when needed – leveraging relevant data for customer insights, product offerings and innovation;
- Open and flexible products and pricing – digitising the Bank's product offerings to enable self-service and dynamic pricing with access to third-party offerings; and
- Cost-effective, optimised technical landscape – reducing operational cost, by renewing legacy systems through the use of new technology opportunities.

Product-Centric Delivery Model

The Bank has implemented a business and product centric delivery model, allowing for agility, quicker time to market and tailor-made solutions to meet changing customer demands. The delivery model is based on cross-functional product teams that prioritise initiatives in line with the Bank's strategy, executing in two-week sprints with the aim of delivering high business value frequently and lowering risk by delivering incremental changes rapidly.

The product teams have enabled the Bank to support its customers through COVID-19 with automated processes and self-service solutions, including digital support loans, the freezing of loans, private pension savings withdrawals and amendments to loan terms.

Digitisation

The Bank's mobile app has been in continuous development with new functionality and user experience improvements resulting in a significant increase in usage. The development of automated digital signatures for individuals and legal entities, along with electronic signatures, has created further opportunities for increased self-service and automation. The Bank's staff are now able to use electronic signatures for most business processes, with records maintained in accordance with legal requirements, reflecting a 200% increase in the number of electronically signed documents in the Bank's businesses since the beginning of 2020.

The Bank has placed emphasis on digital solutions for corporate customers. A major step in improving the corporate customer experience involved offering the mobile app for customers of the Corporate & Investment Banking and Business Banking divisions, including a unified login and on-boarding for basic accounts and securities.

The loan domain has been an important focus area for digitalisation. The development of an automated digital process for customers to refinance their mortgages in the online bank has been integral in allowing the Bank to respond to an unprecedented increase in applications for loan refinancing during COVID-19. Digital green car loans have also been added to the Bank's sustainable product offerings.

The Bank will continue to focus on creating core capabilities. The key initiatives of the Bank include:

- in the short term (0-6 months): overdraft application digitisation, carbon calculator and securities and fund trading on the mobile app;
- in the medium term (6-12 months): automated sales funnel, Payment Services Directive 2 compliance, electronic notarisation, universal credit checks, loan migration and customer analytics service; and
- in the long term (12+ months): open banking, pricing digitisation, Account2Account and foreign payment review.

Open Banking

The Bank has approved an open banking strategy, acknowledging that success in the open banking world requires strategic positioning beyond regulatory compliance. The key elements of the open banking strategy include the following:

- focusing on the lending product area;
- implementing the proposed Payment Services Directive 2 regulations, with a key focus on defining a comprehensive third-party commercial and support model; and
- optimising its mobile app to lay the foundation for open banking, including integrating an account aggregation and loyalty engine into the mobile app that is "Payment Services Directive 2 ready" and would allow for expansion into the Nordics region.

The Bank is also focused on its fintech partnerships and will continue to explore further opportunities. Its current partnerships include:

- Payday: offering small businesses an accounting and payroll service;
- Boost.ai: providing chatbot capabilities across all channels;
- Iceland's leading loan price comparison website (in progress): integrating the Bank's affordability and loan origination capabilities into its website.

Data Powerhouse

The Bank aims to offer better service empowered by data-driven insights. A data-centric culture ensures that targeted innovation is encouraged with the aim of solving real business problems. The strategy focuses on building a strong technical foundation, instilling a data-driven culture and building innovative solutions, such as a customer insight service.

The Bank has invested significantly in data governance, reporting and analytical capabilities over the last couple of years and will continue to improve data access in support of the increased data demand from the business.

Building a data-centric culture ensures that targeted innovation is encouraged with the aim of solving real business problems. The Bank will build a data-driven culture through data literacy and training initiatives, a collaboration platform for employees, and targeted recruitment strategies.

The Bank also aims to pilot specific customer service focused data initiatives, such as customer analytics and lifetime value, personalised marketing, and recommendation engines.

Comprehensive Cyber Security

Cyber security plays a critical role in the digital growth of the Bank. The digital threat landscape is evolving, with the number of threats doubling over the last 12 months, with an average of 400,000 threats per month successfully defended against in 2020. The Bank has a comprehensive cyber security approach, focusing on:

- continuous technology updates and a refresh programme,
- state-of-the-art monitoring and control technologies,
- secure development practices, and
- guidelines, scientific risk assessment and management.

The Bank's Operational Risk Policy, Security Policy, Outsourcing Policy and IT Governance Policy form the basis of the measures used by the Bank to ensure the security of information, data systems and communication systems.

Despite increased threat levels resulting from external attacks and compromises, the Bank has successfully prevented data loss during the past five years.

Employees

During 2020, the average number of employees in the Group was 910 (compared to 1,079 in 2019 and 1,076 in 2018). As at 31 December 2020, the number of FTEs in the Bank was 745, which decreased to 739 FTEs as at 31 March 2021 (774 FTEs in the Group).

As at 31 December 2020, approximately 57% of the Group's employees were female, and approximately 43% of the Group's employees were male, with the Executive Committee comprised of 43% female members and 57% male members. As at 31 December 2020, the management of the Bank were comprised of 48% female members and 52% male members, and the Board of Directors was comprised of 57% female members and 43% male members. The Bank aims to be a global leader in gender and pay equality.

As at 31 December 2020, 64% of the Group's employees had a bachelor or higher educational degree and 36% employees received some other form of education.

The Bank believes it has had exceptional employee engagement, with high employee satisfaction, productivity and engagement from the Bank's shared vision. Corporate satisfaction rates, based on yearly employee surveys, ranked at 4.3 out of 5 in 2018 and 2019 and increased to 4.4 out of 5 in 2020.

Properties

The Bank operates its business through its network of branches, its cash centre and its headquarters, all of which are located in Iceland. The following table sets out the properties that are material to the Group's operations.

Site	Ownership	Location	Lease Termination
Headquarters	Leased	Hagasmári 3, 201 Kópavogur	30 November 2031
Records centre	Leased	Fosshális 17-25/Draghális 18-26 110 Reykjavík	31 December 2024
Main branch 1	Leased	Hagasmári 3, 201 Kópavogur	28 February 2026
Main branch 2	Leased	Suðurlandsbraut 14, 108 Reykjavík	31 May 2023
Akranes branch	Leased	Dalbraut 1, 300 Akranesi	1 March 2022

Investments

As at the dates and for the periods indicated, the Bank had investments in the following associates:

	As at 31 March	As at 31 December		
	2021	2020	2019	2018
Auðkenni hf., an information security company ...	23.8%	23.8%	23.8%	23.8%
JCC ehf., a cash centre service company..............	33.3%	33.3%	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company..	30.1%	30.1%	30.8%	30.8%

	For the three months ended 31 March	For the year ended 31 December		
	2021	2020	2019	2018
			(ISK in millions)	
Investments in associates at the beginning of the year..	775	746	682	704
Additions during the year.....................................	—	—	—	86
Sales of shares in associates.................................	—	—	—	(39)
Transfer from associates to subsidiaries................	—	—	—	(80)
Share of gain of associates...................................	6	44	64	29
Reversal of impairment for an associate................	60	—	—	—
Dividends paid..	—	—	—	(18)
Transfer to "Non-current assets and disposal groups held for sale"..	—	(15)	—	—
Investments in associates...................................	**841**	**775**	**746**	**682**

Legal Proceedings

Due to the nature of the business, litigation and other legal proceedings are a common occurrence in the banking industry. Once professional advice has been obtained and the amount of any possible loss has been reasonably estimated, the Bank takes appropriate steps to mitigate any adverse effects that a given claim may have on its financial standing. Except as described below, there are no governmental, legal or arbitration proceedings (including such proceedings that are pending or threatened of which the Bank is aware) during the 12 months preceding the date of this Prospectus, which may have, or have had, a significant effect on the Bank's and/or the Group's financial position or profitability.

Borgun hf. – Landsbankinn case

Borgun, a former subsidiary of the Bank, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun in late 2014. Landsbankinn claims that Borgun's management did not disclose all available information that might have affected the value of Borgun during the sales process, namely, the value of its stake in Visa Europe which was sold to Visa International shortly after Landsbankinn sold its stake in Borgun. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit against Borgun and others on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. Landsbankinn does not quantify the claim, but its estimate of the lost profit from having sold its shares in Borgun prior to the sale of Visa Europe is approximately ISK 1,930 million. Court-appointed assessors presented their assessment in November 2019. A reassessment was demanded, and the senior assessors appointed by the court presented their reassessment in April 2021 which corroborates the previous assessment of Borgun's obligation to disclose. Further, the senior assessors estimated that Borgun's share in the Visa option as of 31 December 2013 amounted to at least ISK 387 million. It is uncertain when a ruling is to be expected.

In July 2020, the Group closed an agreement on the sale of its stake in Borgun. In that agreement, the Bank undertook to reimburse 63.47% of losses incurred by Borgun or the buyer in the event of an unfavourable outcome in the Landsbankinn case, however such reimbursement was never to exceed the Bank's share in the purchase price (approximately EUR 17.2 million). Since the amount of the claim, the allocation of liability and the possible outcome remain uncertain, the Group has not recognised a provision as a result of this event.

105 Miðborg Project

The professional investor fund 105 Miðborg slhf. is operated by Iceland Funds, a wholly owned subsidiary of the Bank. The fund's main investment is a real estate project at Kirkjusandur in the centre of Reykjavík. The fund decided to terminate its contractor agreement with ÍAV hf. on 19 February 2021 where the main reason for the termination relates to a significant non-performance and delays in the construction of one of the office buildings on the premises. The contractor, ÍAV hf., has claimed both cost for additional work and damages from the fund and Iceland Funds, *in solidum*, in the amount of approximately ISK 3,829 million plus late payment interest from 19 April 2021 and legal costs, to compensate for the alleged unlawful termination and to settle the construction agreement. The case was officially filed on 11 May 2021 at the District Court of Reykjavík, where the fund and Iceland Fund were granted respite to file a written brief containing their counterarguments. In a written brief of dismissal, Iceland Funds has opposed their involvement in the case on the basis that the contractual relationship was between ÍAV hf. and 105 Miðborg slhf. A demand has been made for the attachment (*kyrrsetning*) of the fund's, and its general partner's, 105 Miðborg GP ehf., assets before the District Magistrate Office as a result of the claim being made by ÍAV in the court case. On 4 June 2021 the fund issued a subpoena against ÍAV hf. claiming a reimbursement of the excess payment made in respect of the construction and a payment of compensation for delay and damages due to significant breaches of contract. The claim amounts to approximately ISK 3,878 million plus late payment interest from 4 June 2021 and legal costs. The case will be filed on 29 June 2021, where it will be requested that the two cases will be merged and pursued jointly. The Bank owns a 6.25% stake in the fund. The Group has not recognised a provision in respect of this matter.

EC-Clear case

Kortaþjónustan ehf. (and later EC Clear ehf.) has repeatedly filed suits against the Bank, Valitor hf., Landsbankinn hf. and Arion Bank hf. *in solidum* for damages of approximately ISK 923 million resulting from anti-competitive behaviour of the parties during the period 2003-2013, as confirmed by the ICA with decision No. 8/2015. The Court's ruling, announced on 29 March 2017, confirmed the dismissal of the case due to inadequate presentation of Kortaþjónustan ehf.'s pleadings. Kortaþjónustan ehf. appealed the case to the Supreme Court of Iceland which dismissed the case on 1 June 2017. Since then, the claim has been brought up several times, before and after the transfer of Kortaþjónustan's rights to EC-Clear ehf. The cases have in all instances been dismissed, in June 2018, in February 2019 and the latest in March 2021. Given the background of the case the Bank cannot rule out that a suit will be filed again. The Group has not recognised a provision in respect of this matter.

REGULATORY OVERVIEW

Principal Legislation and Regulations

In Iceland the Group is subject to financial services laws and regulations, corporate governance rules and administrative requirements overseen by various regulatory bodies. The nature and extent of the regulation vary, but such regulation typically will require a company carrying out specified activities to obtain authorisation from a regulator to carry on those activities and, consequently, to comply with various prudential and conduct of business rules, among other requirements.

Acts relevant to the operations of the Group include the Public Limited Companies Act, the Financial Undertakings Act, the Annual Accounts Act, the Securities Transactions Act, the Disclosure Requirements Act, the Deposit Guarantees Act, the Recovery and Resolution Act, the Payment Services Act, Act No. 33/2013 on Consumer Credit, as amended, Act No. 118/2016 on Mortgage Credit to Consumers, as amended, the Pension Funds Act No. 129/1997, as amended, the Insurance Activities Act, the Foreign Exchange Act, the AML Act, the Interest Act, the Financial Activities Supervision Act, the Data Protection Act, the Prospectus Act, the European Financial Market Supervision System Act, the Competition Act. and the Private Limited Companies Act. In the context of a listing, the Stock Exchanges Act and the Central Securities Depositories Act are also relevant to the Group.

Financial Undertakings Act

The purpose of the Financial Undertakings Act is to ensure that financial undertakings operate in a sound and reasonable manner and act in the interests of customers, shareholders, guarantee capital owners and the national economy.

The Financial Undertakings Act sets out the activities requiring an operating licence and the procedure to follow to obtain and hold an operating licence in addition to the rules on qualifying holdings and large exposures. The Group is licensed to operate as a commercial bank under the Financial Undertakings Act to carry out specific authorised activities and provide other services. As part of this licence, the Group may also carry out ancillary activities naturally linked to those authorised activities.

The Bank and its operations are further subject to regulations adopted by virtue of the Financial Undertakings Act, and rules and guidelines issued by the FSA, in addition to numerous other regulations overseeing the financial markets.

In addition, the Financial Undertakings Act also serves to supplement the Public Limited Companies Act in relation to the composition of the board of directors, corporate governance and employees with respect to the rules specific to financial undertakings. There are additional rules relating to risk management, liquidity, equity requirements, accounting, financial reorganisation and sanctions for breaches of certain provisions of the Financial Undertakings Act.

The Financial Undertakings Act also introduced a number of European Union instruments into national Icelandic law through the enactment of the Financial Undertakings Act. These instruments include: Directive (93/22/EEC) on investment services in the securities field; Directive (86/635/EEC) on the annual accounts and consolidated accounts of banks and other financial institutions; Directive (107/2001/EC) amending Directive (85/611/EEC); Directive (95/26/EC) amending a number of directives, with a view to reinforcing prudential supervision; Directive (2009/110/EC) on the taking up, pursuit and prudential supervision of the business of electronic money institution; the Payment Services Directive; the CRD IV and the CRR.

Pursuant to Iceland's obligations under the EEA Agreement, a number of amendments have been made to the Financial Undertakings Act since its enactment. These amendments include the implementation of Directive (2002/87/EC) on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate; Directive (2001/24/EC) on the reorganisation and winding up of credit institutions, and MiFID, as well as amendments to reflect the implementation of CRD IV. See "*—Capital Requirements Directive.*"

Most recently the Financial Undertakings Act was amended with Act No. 11/2021 from 5 March 2021 (ring-fencing around investment banking activities). The amendment act supplements the Financial Undertakings Act with a single provision, the purpose of which is to ring-fence the proportion of investment banking activities of commercial and savings banks. It limits commercial banks and savings banks from taking direct and indirect positions in financial instruments, save for bonds held outside of the trading book and commodities, to the extent that the combined capital requirement of the bank or savings bank for the position may not exceed 15% of its capital base, calculated on a consolidated basis. The amendment, which will not enter into force until 1 January 2022, is a result of proposals prepared by a working group appointed by the Ministry of Finance and Economic Affairs to introduce legislative proposals based on the white paper on the future vision of the Icelandic financial system. See "*—White Paper*."

The Financial Undertakings Act is supplemented by secondary legislation in the form of regulations and rules enacted by the executive branch of government.

Bank Recovery and Resolution Directive

The BRRD establishes an EU-wide framework for the recovery and resolution of credit institutions and investment firms. The purpose of the BRRD is to equip the relevant regulatory authorities with a range of powers so that they may intervene in an ailing or distressed entity so as to ensure its continuity and minimise any potential impact on the economy and financial system.

The provisions of the BRRD have been implemented into Icelandic law by means of a combination of legislative acts.

First, the passage of Act No. 54/2018, amending the Financial Undertakings Act and entry into force of Regulation No. 50/2019 on Recovery Plans of Credit Institutions and Investment Firms implemented the BRRD provisions focusing on recovery plans and timely intervention to prevent an economic shock to financial institutions operating in Iceland.

Second, the enactment of the Recovery and Resolution Act further amended the Financial Undertakings Act implemented the parts of the BRRD that provide for the resolution process, from preventive measures and preparation, to decision-making and the implementation of each resolution. Under the Recovery and Resolution Act, the Central Bank of Iceland possesses powers of resolution and can take action and prepare and execute resolution procedures on behalf of credit institutions and investment firms.

As the Resolution Authority, the Central Bank of Iceland oversees the preparation and implementation of each resolution and a special funding resource, the Resolution Fund, which is intended to finance the resolution process. Additionally, the Act also provides for the implementation of Minimum Requirement for own funds and Eligible Liabilities (MREL) in Iceland and amended the amount guaranteed in the deposit guarantee scheme under which payments to each depositor are now guaranteed up to the equivalent of EUR 100,000 in ISK.

On 4 May 2021, the Parliament passed a bill that implements Directive 2017/2399/EU with regard to the position of unsecured debt instruments in the insolvency hierarchy and amends the Recovery and Resolution Act accordingly. The Act further implemented conformation amendments to the Financial Undertakings Act and the Deposit Guarantees Act.

Capital Requirements Directive

The Basel Committee on Banking Supervision issued the first version of the Basel III framework in December 2010 and a revised version in June 2012. The Basel III framework is a new international regulatory framework for banks and credit institutions and sets out revised capital and (minimum) liquidity requirements to reinforce capital standards. In addition, the framework includes requirements regarding regulatory capital, liquidity, leverage ratio and counterparty credit risk measurements. On 26 June 2013, the European Parliament and the European Council adopted CRD IV (which consisted of both the CRR and the associated Capital Requirements Directives) for the implementation of the Basel III framework in the European Union with the aim of strengthening the regulation of the banking sector. CRD IV replaces the current Capital Requirements Directives.

The enactment of the CRD IV Directive into Icelandic law is subject to staggered implementation and has involved numerous amendments.

The first amendment was introduced on 9 July 2015 by Act No. 57/2015 which amended the Financial Undertakings Act and incorporates into Icelandic law the CRD IV Directive's provisions on capital buffers and regulation implementing the provisions of the CRR and other technical standards.

The second amendment, introduced on 1 September 2016 by Act No. 96/2016, amended the Financial Undertakings Act and incorporated the CRD IV's provisions on operating licences, initial capital, information obligations, leverage ratios, supervisory review and the evaluation process.

The third amendment, introduced on 9 May 2017 by Act No. 23/2017, includes an obligation on financial undertakings to establish effective and reliable mechanisms to enable employees to report potential or actual breaches of laws and / or regulations that apply to the undertakings.

The fourth amendment, introduced on 19 June 2018 by Act No. 54/2018, further amended the Financial Undertakings Act and introduced provisions on supervision and prudential requirements on a consolidated basis, co-operation with supervisors in other countries in the European Economic Area and a legal basis for the regulation on large exposures.

The fifth amendment, introduced on 18 February 2019 by Act No. 8/2019, amended the Financial Undertakings Act and included provisions regarding the board of directors and auditing. The remaining features of the CRD IV Directive (not already incorporated by the amendments outlined above) are still to be implemented into Icelandic law.

The remainder of the CRR was enacted into Icelandic law by the entry into force of Regulation No. 233/2017 on 6 March 2017, although Articles 500 and 501 of CRR, the latter one stipulating capital requirements deduction for credit risk on exposures to SMEs, only came into effect on 1 January 2020 following the incorporation of CRR into the EEA Agreement. The second SME factor, as stipulated in CRR2, is expected to be implemented as the regulation will be incorporated into the EEA agreement. Once implemented, the second SME factor is expected to materially lower the Bank's REA.

On 11 May 2021, the Parliament enacted an amendment act to the Financial Undertaking Act. The most notable amendments enable the Minister to implement CRR II and EU Regulation 2019/630 amending CRR as regards minimum loss coverage for non-performing exposures (NPEs), which aims to accelerate the reduction of non-performing loans in the banking sector, by way of issuing secondary legislation in the form of regulations. Moreover, the amendments will enable the Central Bank of Iceland to implement related secondary EU legislation based on technical standards, which have already been incorporated into the EEA Agreement. Those amendments will enter into force on 28 June 2021, as the better part of CRR II will enter into force in the European Union on that date and it is expected that Regulation 2019/630 will be incorporated into the EEA Agreement next June. According to the supplementary notes with the act the government expects to transpose Regulation 2019/630 and CRR II on that same date (28 June 2021) via amendments to Regulation No. 233/2017.

Liquidity Coverage Ratio

The Central Bank of Iceland introduced the LCR Rules, which became effective on 31 March 2017 and were amended by Rules No. 1170/2019 on 18 December 2019 and Rules No. 1399/2019 on 28 December 2020. The LCR Rules replaced previous Rules No. 1031/2014 and are based on liquidity standards introduced in the Basel III Accord, which began a global and phased implementation from October 2015.

The objective of the LCR Rules is to promote the short-term resilience of the liquidity risk profile of banks. This objective is achieved by imposing on banks a requirement to have an adequate stock of unencumbered high-quality liquid assets that can be quickly and easily converted into cash (in private markets) to meet the bank's liquidity needs for a 30 calendar-day liquidity stress scenario. Therefore, the LCR is the balance between highly liquid assets and the anticipated net cash outflows of a bank in the following 30-day period under stressed conditions.

The LCR methodology provides for bank assets to be divided into categories according to their liquidity. For an asset to qualify as highly liquid under the LCR Rules, the asset must be non-pledged, liquid and easily priced on private markets and not issued by a bank or any related entities. In accordance with the rules established by the Central Bank of Iceland, Icelandic banks must maintain a minimum LCR requirement of 100%, and the liquidity ratio in all foreign currencies combined must be at least 100% at any time. Icelandic banks are also required to maintain a liquidity coverage ratio in Icelandic Króna of at least 50%. This requirement is being introduced incrementally beginning at 30% through 2020 and 2021, increasing to 40% on 1 January 2022 and finally reaching the full 50% at the beginning of 2023. A credit institution must also submit regular reports on its liquidity position to the Central Bank of Iceland.

The LCR methodology also provides for a bank's deposit base to be split into categories according to customer type. A further categorisation is used where term deposits refer to deposits with a residual maturity in excess of 30 days. Deposits capable of being withdrawn within 30 days are marked stable if the customer has a business relationship with the bank, and the amount is covered by the Depositors' and Investors' Guarantee Fund. The Depositors' and Investors' Guarantee Fund is a fund established in Iceland pursuant to the provisions of the Deposit Guarantees Act and that guarantees a minimum level of protection to depositors in commercial and savings banks and to customers of companies engaging in securities trading pursuant to the relevant laws. Other types of deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions.

If the Bank's liquid coverage ratio falls below the minimum LCR standards or if reporting requirements are not met, the Central Bank of Iceland can impose daily fines to the shortfall under the LCR Rules.

Data Protection Act

The Data Protection Act implemented the General Data Protection Regulation (EU) (2016/679) ("**GDPR**") into Icelandic law. The GDPR introduced significant changes to the data protection legislation in the European Union and by extension the Data Protection Act fundamentally amended the Icelandic data protection regime. These requirements include but are not limited to implementing certain policies and processes, developing an effective internal data protection management system and appointing a data protection officer. Should companies be found in noncompliance with the GDPR, DPA can impose fines, determined by the level of the infringement, of up to 4% of the company's annual worldwide turnover.

Securities Transactions Act

The Securities Transactions Act regulates, among other things, the activities of financial institutions operating in the securities market, the handling of insider information, the price formation on a regulated market and takeover rules for Icelandic listed companies. These provisions apply to the Group by virtue of it being an issuer of securities and the capital markets operations of its Investment Banking division or, similarly, the asset management operations through the Asset Management division or its subsidiary, Íslandssjóðir (Iceland Funds).

The purpose of the Securities Transactions Act was to establish a clear and consistent regulatory framework to safeguard investors and create a common internal market for financial services with a focus on increased supervision, professional execution and information disclosure.

A secondary purpose of the enactment of the Securities Transactions Act was to transpose into national law MiFID, the Transparency Directive, the Market Abuse Directive, and Directive 2004/25/EC on takeover bids.

These rules are designed to consider subsequent developments in the trading environment since the implementation of MiFID and following the financial crisis to improve the functioning of financial markets in terms of their efficiency, resiliency and transparency. MiFID and MiFIR empower ESMA to develop technical standards. MAR, MiFID 2 and MiFIR are expected to be implemented into Icelandic legislation on 1 September 2021 resulting in amendments to *inter alia* the Securities Transactions Act. See "*—Proposed Legislative Amendments*".

Further legislative changes are expected to be made in the near future to bring Icelandic law in line with more recent developments in the European Union. See "*—Proposed Legislative Amendments*". Secondary legislation in the form of regulations and rules enacted by the executive branch of government supplement the Securities Transactions Act.

Disclosure Requirements Act

The Disclosure Requirements Act was enacted on 16 March 2021 and entered into force on 1 May 2021. The purpose of the enactment was to transpose the Transparency Directive from the Securities Transactions Act, where it was previously reflected, into a separate legislation and implement later amendments to the Transparency Directive and related secondary EU legislation. The purpose of the Act is to ensure the transparency of information regarding issuers of securities which have been admitted to trading on a regulated market and thereby protect the interests of investors and the efficiency of the market.

The legislation sets out provisions relating to major holding announcements and information disclosure requirements for issuers of listed securities with respect to periodic and other information. Among changes implemented into Icelandic law by the Disclosure Requirements Act was the definition of an issuer under the Act as it stipulates that an issuer can be, in addition to a legal person, a natural person which is an issuer of securities traded on a regulated market. Furthermore, the deadline for issuers to disclose half-yearly financial statements was extended by one month; from two months from the end of the relevant half-year period to three months. An issuer shall furthermore ensure that the half-yearly financial statements are available to the public for a period of a minimum ten years, instead of five years as used to apply under the Securities Transaction Act. Moreover, the deadline for major holdings announcements to the issuer and FSA was extended from no later than the trading day immediately following the date on which the notification requirement arose to a maximum of four trading days from the relevant transaction. The deadline for an issuer to disclose such information to the public was also extended from the trading day immediately following the date of receipt of an announcement to three trading days from such receipt.

Prospectus Act

The Prospectus Act transposed the Prospectus Regulation into Icelandic law, with minor adaptations resulting from the decision of the EEA Joint Committee No. 84/2019. The Prospectus Act is supplemented by secondary legislation in the form of regulations implementing the Commission Delegated Regulation (EU) 2019/980 and the Commission Delegated Regulation (EU) 2019/979 of 14 March 2019. The Prospectus Act exempts the public offering of securities from the obligation to publish a prospectus where the total amount of the offering is lower than the equivalent of EUR 8,000,000 in Icelandic Króna and the offering is not subject to notification in accordance with Article 25 of the Prospectus Regulation. Where the total amount of the offering is between the equivalent of EUR 1,000,000 and EUR 8,000,000 in Icelandic Króna such exempt public offerings must however be notified to the FSA.

The Prospectus Act stipulates that the responsibility for the information provided in a prospectus rests with the issuer or the board, its executive or supervisory board, the bidder, the person requesting the admission of securities to trading on a regulated market or the guarantor, as applicable and identified in a prospectus. The Act provides that a financial undertaking so authorised under its operating license shall oversee the public offering of securities and admission to trading on a regulated market that are not exempt from the obligation to publish a prospectus. The FSA shall oversee the approval of prospectuses and a prospectus may not be published until the FSA has approved it. In accordance with the EEA Agreement, the FSA and the EFTA Surveillance Authority shall carry out the relevant supervision in accordance with the Act.

European Financial Market Supervision System Act

For the purpose of legislating a harmonised European supervision system in the Icelandic financial market the Parliament enacted the European Financial Market Supervision System Act in May 2017. The supervision system is intended to protect the interests of the public and the financial market by promoting the stability and health of the financial system in the internal market of EEA. The Act transposed numerous EU regulations into Icelandic law, more specifically Regulation (EU) 1093/2010 of 24 November 2010, establishing EBA, Regulation (EU) 1094/2010 of 24 November 2010, establishing EIOPA, Regulation (EU) 1095/2010 of 24 November 2010, establishing ESMA and Regulation (EU) 1092/2010 of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB).

The European Financial Market Supervision System Act provides that the FSA and the EFTA Surveillance Authority shall carry out supervision in accordance with the Act, in line with the EEA Agreement, cf. Act No. 2/1993, and the agreement between the EFTA States on the Establishment of a Surveillance Authority and a Court of Justice. Furthermore, the FSA, other authorities, individuals and legal entities may provide European supervisory bodies with information and data, as further provided in the Act or other acts, for the performance of supervision. This authorisation also covers data which is subject to confidentiality under the Financial Activities Supervision Act or on the basis of other laws.

Under Article 16 of the above EU regulations EBA, ESMA and EIOPA shall, with a view to establishing consistent, efficient and effective supervisory practices, and to ensuring the common, uniform and consistent application of EU law, issue guidelines and recommendations addressed to competent authorities or financial market participants. Financial market participants, such as the Bank, shall make every effort to comply with those guidelines and recommendations. The FSA publishes such guidelines on its homepage and the FSA proposes the guidelines as a basis for assessing compliance with applicable law and secondary legislation. This includes Article 19 of the Financial Undertakings Act which provides that financial undertakings shall operate in accordance with proper and sound business practices and customs on the financial market, as Rules No. 1001/2018 further outlining obligations under Article 19 of the Act provide that compliance with such EU guidelines is among the factors that the FSA can use to assess whether the operations of financial undertakings are in accordance with proper and sound business practices and customs on the financial market.

Deposit Guarantees Act

Any party engaged in securities trading pursuant to Icelandic law and established in Iceland, such as commercial banks, savings banks and companies providing investment services, are members of the Depositors' and Investors' Guarantee Fund according to the Deposit Guarantees Act. The Act is based on Directive 1994/19/EC on deposit guarantee schemes. See "*Icelandic Securities Market—Compensation Scheme for Investors.*" Directive 2014/49/EU on deposit guarantee schemes is still to be implemented into national law. Its objective is to ensure a harmonised level of deposit protection by all recognised deposit guarantee schemes, regardless of the location of the deposits in the European Union.

Payment Services Act

The Payment Services Act was introduced to ensure transparency of any conditions and information requirements for payment services, rights and obligations in relation to the provision and use of payment services, surveillance, implementing measures and sanctions. The act applies to all electronic payments, including payments made by credit cards, debit cards and bank transfer payments.

The Payment Services Act implemented the Payment Services Directive into Icelandic law and has since been amended to include the provisions of the Electronic Money Directive.

Proposed new Payment Services Act

It is proposed that a new Act on Payment Services transposing the Payment Services Directive 2 enter into force on 1 July 2021 in Iceland. After the entry into force of the new Payment Services Act, the ministry and the FSA will set rules for further implementation, which will start with the implementation of the derivative acts of the Payment Services Directive. The delegated EU Regulation 2018/389 on strong authentication and secure communication (e.g., regulatory technical standards on strong customer authentication and common and secure open standards of communication) is expected to enter into force as soon as the revised law on payment services is passed on 1 July 2021 (although implementation will not take place until 10 January 2022). This means that payment service providers that provide accounting services (banks) must have a testing facility by the time the Act enters into force. The six-month trial period on banks' online interfaces with third parties must be fully completed by 10 January 2022. The Bank has taken steps to implement the Payment Services Directive 2.

In terms of content, the Payment Services Directive 2 sets out strict security controls for electronic payments and the protection of consumers' financial data, increases the transparency of conditions and information requirements for payment services, and sets out rules concerning the rights and obligations of users and providers of payment services. Separately, it is the intention of the Payment Services Directive 2 to open up the payment markets to new entrants, which, in turn, should lead to increased competition in the market. The Payment Services Directive 2 is complemented by the EU Interchange Fee Regulation on interchange fees for card-based payment transactions, which places a limit on the fees charged between banks for card-based transactions.

Foreign Exchange Act

Following the financial crisis, the Parliament of Iceland passed Act No. 134/2008 on 28 November 2008, which, amongst other things, amended the Foreign Exchange Act and bestowed upon the Central Bank of Iceland powers to intervene in the currency market where the view was taken that the foreign exchange rate of the Icelandic Króna needed stabilising. The Central Bank of Iceland introduced Capital Controls by implementing Rules No. 1082/2008, which were amended several times before the Capital Controls were enacted into primary legislation with the adoption of Act No. 127/2011, which also amended the Foreign Exchange Act.

The Foreign Exchange Act contains statutory exemptions to the Capital Controls, and also provides that the Bank can apply to the Central Bank of Iceland to seek approval for a specific exemption. In March 2017 and April 2019, the Central Bank of Iceland set out a range of new general exemptions to the majority of the Capital Controls, with restrictions remaining on (i) derivatives trading for purposes other than hedging, (ii) lending by residents to non-residents in certain prescribed circumstances and (iii) special reserve requirements in circumstances where there is a new inflow of foreign currency. By March 2019, the reserve requirements due to new inflows of foreign currency was down to 0%, effectively cancelling the reserve requirements. With that said, it remains unclear when and if the Capital Controls will be lifted in full. If the economic situation in Iceland were to change, the Central Bank of Iceland might re-impose some or all of the Capital Controls that have previously been in place.

Before the general exemption was introduced, the Capital Controls effectively prohibited the cross-border transfer of funds, except in certain circumstances, such as the payment for goods or services and transfers permitted under applicable statutory exemptions. Therefore (unless expressly permitted) financial transactions resulting in cross-border currency transactions and including lending and borrowing between resident and non-resident parties, as well as currency derivatives of any kind and the acquisition by domestic parties of financial instruments denominated in foreign currency, were prohibited. As a result, the Capital Controls made it compulsory for Icelandic nationals and companies to repatriate all foreign currency not subject to those statutory exemptions.

Proposed new Foreign Exchange Act

On 16 February 2021, the Minister submitted a draft bill to the Parliament for a new Foreign Exchange Act, which is expected to be accepted and entered into force mid- or second half of 2021, subject to Parliamentary processes and acceptance.

The draft bill is based on the principle that foreign exchange transactions, cross-border payments and the flow of capital between countries are free and unrestricted, but with the proviso that certain protective measures can be applied, for example, in the form of macroeconomic prudential instruments or measures comparable to the Capital Controls that were established in the wake of the bank collapse in 2008.

There has been a growing consensus internationally in recent years that the free flow of capital is not beneficial in all circumstances. The bill contains authorisations for the Central Bank of Iceland to set rules in favour of macroeconomic prudence to enable households and companies to benefit from capital flows between countries without creating systemic risks that could cause instability with associated risk for the same parties.

Among the three measures in favour of macroeconomic prudence proposed in the bill is the authority to set rules on special reserve requirements for the inflow of foreign currency. This is an authorisation to use control instruments to temper and influence the composition of capital inflows into the country, so-called capital flow management measures. Excessive capital inflows can disrupt the transmission of monetary policy and create a risk of financial instability. The authorisation is largely based on a current measure to the same effect in the Foreign Exchange Act. The draft bill proposes that the authority to stipulate a special reserve requirement cover the same types of investments as it currently does. The scope of the authority to lay down rules in this regard is therefore unchanged, although terminology is slightly amended.

The bill further proposes to keep in force a measure currently in the Foreign Exchange Act, allowing the Central Bank of Iceland to set restrictions on lending in foreign currencies to those that are not hedged against currency risk. This authorisation has been in force since mid-2017 and is a precautionary measure that can be used to prevent significant lending in foreign currencies to exposed parties, thus creating systemic currency discrepancies in the economy. Under these circumstances, an unexpected depreciation of the Króna would simultaneously increase the debt of the economy and reduce the value of mortgages, which could lead to collateral calls and trigger asset sales. Higher debt levels could also force a decrease in consumption and investment when the economy is already in a downturn and thus a significant slowdown in the economic turnaround following the shocks. Systemic currency imbalances in the economy, such as those in the mid-1990s, significantly reduce the economy's resilience to economic shocks and can have serious consequences for household and corporate balance sheets, as well as threaten financial stability. Restrictions on foreign currency lending are of a nature that the IMF has considered to be justified.

The third type of measure proposed in the bill extends to derivatives trading where the Icelandic Króna is against a foreign currency, allowing the Central Bank of Iceland to put forth restrictions on such derivative trading. This restriction has, in fact, been in force since the imposition of the Capital Controls, but the Central Bank has authorised derivatives trading for hedging, subject to the Central Bank of Iceland's confirmation that currency risk exists.

As part of the bill, it is also expected that the Króna Asset Act will be repealed.

AML Act

On 1 January 2019, the AML Act came into force in part and fully entered into force on 1 January 2020, implementing the Fourth Money Laundering Directive and parts of the fifth Directive No. 2018/843. The remainder of the fifth Directive was implemented on 23 July 2020. The aim of the Directives was to align EU law with the International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation, which were adopted by the Financial Action Task Force in 2012.

The focus of the AML Act is to combat money laundering and terrorist financing and do so by requiring parties who carry out activities that could be susceptible to money laundering and terrorist financing to obtain information about their customers and their business activities. Any knowledge of such illegal activities shall entail termination of the business relationship in question and must be reported to the competent authorities. The Act applies to financial undertakings such as the Bank, among others, and requires entities and individuals that fall under the scope of the Act (obliged parties) to follow a risk-based approach in order to identify, understand and mitigate the risks of money laundering and terrorist financing. The Act introduced major changes to previous Icelandic legislation related to anti money laundering and combating the financing of terrorism, such as with respect to the extended scope of the legislation to include new obliged parties, performance of risk assessment to determine the type of customer due diligence required, detailing provisions on politically exposed persons, increased access to information on customers and beneficial owners, increased authority of the relevant authorities, strengthening cooperation and coordination between competent authorities, along with supervision and sanctions.

Competition Act

The Competition Act applies to agreements, terms and actions with effect, or intended effect, in Iceland. The Competition Act is to a significant extent based on EU competition rules, especially Council Regulation (1/2003/EC) on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty as well as Council Regulation (139/2004/EC) on the control of concentration between undertakings. The objective of the Competition Act is to promote effective competition and thereby increase the efficiency of the factors of production of society. This objective shall be achieved by (i) preventing unreasonable barriers and restrictions on freedom of economic operation, (ii) preventing harmful oligopoly and restriction of competition, (iii) facilitating the entry of new competitors into the market, and (iv) promoting a healthy competitive environment for the benefit of consumers.

Stock Exchanges Act

Under the Stock Exchanges Act, Nasdaq Iceland must monitor the compliance of market participants with the laws, rules and conventions applicable to trading in a regulated market and operate an appropriate trade monitoring system. The Stock Exchanges Act sets out the rules on (i) which conditions have to be satisfied by a stock exchange to obtain a licence to operate, (ii) the establishment and functions of stock exchanges, (iii) membership of a regulated market, (iv) admission of financial instruments to trading, (v) transparency in a regulated market, (vi) surveillance and (vii) sanctions. See "*Icelandic Securities Market.*" Nasdaq Iceland is further required to notify the FSA of any suspicion or knowledge of any violation of laws, regulations or other rules applicable to trading in a regulated market or any gross or repeated violation of Nasdaq Iceland rules. Nasdaq Iceland must provide the authorities with appropriate information and assistance for any investigation or prosecution arising out of suspicion of criminal conduct in a regulated market or through its marketing systems.

A draft bill for a new legislation transposing MiFID 2 and MiFIR into Icelandic law, the Act on Markets for Financial Instruments, is expected to be implemented on 1 September 2021. Accordingly, the bill will repeal the legislation which reflected MiFID, including the Stock Exchange Act. See "*—Proposed Legislative Amendments*".

Insurance Activities Act

The Insurance Activities Act was enacted in September 2016 and applies to the Bank's subsidiary Allianz Ísland hf., The Act transposed into Icelandic law the provisions of the Directive 2009/138/EC on the taking-up and pursuit of the business of insurance and reinsurance (the "**Solvency II Directive**") as amended by Directive 2014/51/EU ("**Omnibus II Directive**"), except for provisions regarding EIOPA's powers and consolidated insurance companies. The rules on EIOPA's powers were implemented into the Insurance Activities Act in May

2018 when certain parts of the Omnibus II Directive were transposed into Icelandic law. Additional amendments have been made to the Act to further harmonise Icelandic legislation with EU insurance regime.

EU Interchange Fee Regulation

Act No. 31/2019 implemented the EU Interchange Fee Regulation in September 2019. Under the EU Interchange Fee Regulation, interchange fees in the European Union have been capped at 0.3% of transaction value for credit cards and the lesser amount of 0.2% or €0.05 per transaction for debit cards. EU member states may implement even lower caps.

Other EU Instruments

In recent years various other European Union instruments have been transposed into Icelandic law and regulations. This includes the MCR, which was transposed into legislation with Act No 118/2016 and entered into force on 1 April 2017; the SSR, which was transposed into legislation with Act No. 55/2017 and entered into force on 1 July 2017; and the EMIR, which was transposed into legislation with Act No. 15/2018 that entered into force on 1 October 2018 and was amended on 18 May 2021 to implement Regulation (EU) 2019/834 (EMIR Refit) amending EMIR, the CSDR which was transposed into legislation with the Central Securities Depositories Act and entered into force 21 February 2020, Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFMD), which was transposed into legislation with Act No. 45/2020 on Alternative Investment Fund Managers and entered into force on 25 May 2020 and Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds, which was transposed into legislation with Act No. 7/2021 on Financial Benchmarks and entered into force on 8 February 2021.

On 18 May 2021, the Parliament enacted the Act on Key Information Documents for certain packaged Retail Investment Products, transposing Regulation (EU) 1286/2014 on key information documents for packaged retail and insurance-based investment products ("**PRIIPs Regulation**"). The Act will enter into force on 1 July 2021. The PRIIPs Regulation aims to increase the transparency and comparability of such investment products through the issue of a standardised short form disclosure document, or the PRIIPs Key Information Document. This is intended to make it easier for retail investors to understand and compare the key features, risk, rewards, and costs of different products falling within the scope of the regulation.

White Paper

In December 2018 the Icelandic Government published a white paper on the future vision of the Icelandic financial system. The purpose of the white paper was to create a basis for discussion, strategy and decision-making on issues concerning the financial system, its future structure and development. It touches upon various aspects of the financial system and highlights several factors of significance for its operations, its users, the government, and the regulatory authorities. The main conclusion of the white paper is that the future vision of the financial system should be built on three main pillars, which are the principal focus of the white paper; (i) good regulatory framework and robust supervision, (ii) efficiency in banking operations, and (iii) solid ownership of financial undertakings, contributing to sound and prudent operation based on long-term perspectives, noting that changes to the state's ownership of financial institutions will have a significant impact on the future of the financial system. The white paper was introduced in the government's public consultation portal and discussed by the parliament to receive feedback and comments before the commencement of work by the government on preparing proposals for legislative and regulatory changes based on the white paper.

Proposed Legislative Amendments

The financial services laws and regulations relevant to the operation of the Group is by nature subject to continuous amendments. In addition to the proposed legislative amendments summarised in "*—Principal Legislation and Regulations*", some notable legislative amendments intended to transpose into Icelandic law EU instruments regarding the European financial market have recently been proposed by the Icelandic government.

MAR

On 9 March 2021 the Minister submitted a draft bill to the Parliament which will transpose MAR into Icelandic legislation upon entry into force. The Parliament enacted the bill on 25 May 2021, but it will not enter into force until 1 September 2021. The legislation will repeal the parts of the Securities Transaction Act that implemented the Market Abuse Directive and constitute a new legislation on actions against market abuse. However, as CSMAD stipulates minimum punishments for market abuse, and punishments do not fall within the scope of the EEA Agreement, CSMAD was not adopted into the EEA Agreement and will therefore not be implemented into Icelandic legislation. Regardless, the proposed legislation takes into account provisions of CSMAD with respect to punishments for market abuse, as it is deemed important that sanctions for market abuse are comparable with the EU regime.

Following the implementation of MAR into Icelandic law, the harmonised EU rules will apply to measures against market fraud in Iceland. The goal is to promote the integrity of the European securities market, harmonise penalties for infringements and thus prevents regulatory arbitrage, i.e. that market participants circumvent the rules on market fraud by conducting business in one member state rather than another in order to comply with less stringent requirements or that more severe penalties apply to infringements.

MiFID 2 and MiFIR

Subsequent to the submission of the MAR bill the minister submitted to the Parliament a draft bill on 22 March 2021 for new proposed legislation, the Act on Markets for Financial Instruments. The purpose of the Act is to transpose MiFID 2 and MiFIR into Icelandic law and thereby fulfil Iceland's obligations under the EEA Agreement. Accordingly, the bill will repeal the legislation which reflected MiFID, more specifically the Stock Exchange Act and parts of the Securities Transaction Act and the Financial Undertakings Act, which will also be amended further along with other Acts to fully reflect the implementation of MiFID 2 and MiFIR.

The purpose of MiFID 2 and MiFIR, and by extension the purpose of the proposed legislation, is to address the need for a more robust legal framework for financial instruments to ensure transparency, strengthen investor protection, increase investors trust in the market for financial instruments and to improve the functioning of the financial markets in terms of their efficiency and resiliency. The legislation aims to fill regulatory gaps since the transposing of MiFID into Icelandic law and ensure that competent authorities have sufficient powers to carry out their tasks.

The implementation of the new regulatory framework will entail considerable changes to the regime on market for financial instruments in Iceland. For example, MiFID 2 has a broader scope of application than MiFID, considers technological innovations and implements new types of trading venues. MiFIR accounts for increased transparency requirements than MiFID with respect to pre- and post- securities transaction and empowers competent authorities to intervene in the marketing, distribution or sale of certain financial instruments and structured deposits, provided that certain conditions are met. Such intervention powers can further extend to certain financial activities or operations in the financial market.

The bill and its entry into force date is still subject to Parliament discussions and procedures. As MAR, MiFID 2 and MiFIR are related, including with respect to scope and terminology, the structure of the proposed Act assumes that the new Act and the Act transposing MAR will enter into force simultaneously. As MAR will enter into force on 1 September it is expected that the Act on Markets for Financial Instruments will enter into force on that date.

Other notable proposed legislative amendments include the following:

Interest Act

It has been proposed that the Interest Act will be amended such that index-linked annuity loans can only be granted for 10 to 25 years (currently 5 to 40 years), however with certain exceptions concerning the age and financial status of the borrower.

Principal Governmental Authorities

The primary regulatory and inspection bodies active in the Icelandic financial system are described below.

Central Bank of Iceland

The Central Bank of Iceland has a variety of functions, including responsibility for implementing a monetary policy that promotes price stability and foreign exchange reserves and upholding a sound and efficient financial system, including domestic and cross-border payment systems. The Central Bank of Iceland is largely governed by Act No. 92/2019 on the Central Bank. The Central Bank of Iceland imposes a reserve requirement on all commercial banks and savings banks to ensure that they are able to meet fluctuations in their liquidity positions. The Central Bank of Iceland also oversees the surveillance of the Capital Controls and can grant specific exemptions to institutions that make an application. See "*Risk Factors—Risks Relating to Business and Industry—The Capital Controls restrict to some extent the manner in which the Bank conducts its business*".

The FSA and Central Bank of Iceland merged at the beginning of 2020. The FSA is responsible for the supervision of the whole range of financial institutions, as well as insurance companies and pension funds. The FSA supervises the activities of the Bank as a commercial institution. Iceland has implemented a number of European Union instruments regarding financial institutions, and, accordingly, the FSA has extensive authority over such entities.

The activities of the FSA are primarily governed by the Financial Activities Supervision Act and Act No. 99/1999 on the Payment of Costs for Public Supervision of Financial Activities, as amended.

Icelandic Competition Authority (ICA)

The ICA is responsible for enforcing the requirements and prohibitions set out in the Competition Act and, as applicable, Articles 53 and 54 of the EEA Agreement. Its role includes deciding what measures should be taken against institutions that have engaged in anti-competitive behaviour, monitoring the levels of competition and trade practices in specific market sectors in Iceland and investigating the management and ownership of institutions. The ICA also has the power to provide exemptions on the basis of the powers detailed in the Competition Act.

The ICA's focus extends to all types and levels of business activities conducted by individuals, companies, public entities or other parties. The financial markets have received particular scrutiny by the ICA in recent years. In 2011 and 2013, the ICA published reports on the then-current state of financial services in Iceland, with a particular focus on the three major banks: the Bank, Arion Bank and Landsbankinn.

The Bank has made a few settlements with the ICA, concerning both activities in the Bank's daily operations as well as settlements relating to exemptions granted by the ICA from prohibition rules of the Competition Act concerning cooperation between companies. Following recent amendments to the Competition Act, settlements falling in the latter category do not have the same effect as they did before the amendments entered into force and the cooperation is now subject to a self-assessment carried out by the relevant companies. See "*Legal and Regulatory Risk – Regulatory changes or enforcement initiatives could adversely affect the Bank's business"*. Other settlements concluded by the Bank with the ICA remain unaffected by this amendment. These settlements have the objectives of e.g. (i) stimulating competition in banking services for individuals and small businesses, (ii) ensuring that the Icelandic government's ownership of both the Bank and Landsbankinn will not negatively affect competition and (iii) changing the setup and operation of the credit card market. Under the Competition Act, a failure to implement or comply with measures agreed to in a settlement can lead to an investigation lead by the ICA and could ultimately result in administrative fines being imposed.

The ICA can impose administrative fines up to a maximum of 10% of an entity's total turnover of the previous business year of any undertaking or association of undertakings involved in a violation of the Competition Act. The ICA must consider the nature and extent of the violations, their duration and whether a violation has taken place on more than one occasion when determining the level of the fine. The ICA has the power to waive or reduce a fine if it deems a violation as insignificant or if an undertaking has the information or documents to the ICA concerning the violations on their own accord.

Data Protection Authority (DPA)

The DPA exercises surveillance over processing of data as stipulated within the Data Protection Act. The DPA deals with specific cases on the basis of inquiries from public authorities or private individuals or legal entities, or cases taken up by the DPA on its own initiative. The DPA can impose administrative fines up to a maximum of 4% of an entity's worldwide turnover of the previous financial year for non-compliance of the Data Protection Act.

The decisions made by the DPA are final and may not be brought before any other administrative authority. However, the DPA's decision may be brought before courts and complaints concerning the administration of the DPA can be addressed to the Parliamentary Ombudsman.

Consumer Agency

The Consumer Agency is a public surveillance authority that operates on the basis of the Act No. 62/2005 and is entrusted with market surveillance of business operators, good functioning and transparency of the markets in respect to safety and consumers legal rights. The Consumer Agency is also responsible for enforcement of legislation with regards to consumer rights.

The Consumer Agency receives notifications of possible breaches of general safety issues, legal rights of consumers and related legislation. The Consumer Agency has the authority to enforce various actions such as sales bans, recalls and fines.

SELECTED CONSOLIDATED FINANCIAL, OPERATING AND OTHER INFORMATION

The selected consolidated financial information of the Bank as at and for the years ended 31 December 2020, 2019 and 2018 has, unless otherwise stated, been derived from the Annual Financial Statements included elsewhere in this Prospectus.

The selected consolidated financial information set forth below should be read in conjunction with, and is qualified by reference to, "*Operating and Financial Review*" and "*Consolidated Financial Statements*". The results of operations for any period are not necessarily indicative of the results to be expected for any future period.

The selected condensed consolidated interim financial information of the Bank as at and for the three months ended 31 March 2021 has, unless otherwise stated, been derived from the Group's reviewed condensed consolidated interim financial statements for the three months ended 31 March 2021.

Consolidated Income Statement*

	Three months ended 31 March		Year ended 31 December		
	2021	**2020**	**2020**	**2019**	**2018**
			(ISK in millions)		
Interest income	12,784	13,645	55,695	61,965	61,675
Interest expense	(4,594)	(5,065)	(22,324)	(29,143)	(29,738)
Net interest income	**8,190**	**8,580**	**33,371**	**32,822**	**31,937**
Fee and commission income	3,307	2,763	12,651	12,052	19,853
Fee and commission expense	(445)	(272)	(2,126)	(1,153)	(7,626)
Net fee and commission income	**2,862**	**2,491**	**10,525**	**10,899**	**12,227**
Net financial income (expense)	293	(1,738)	(1,391)	(820)	(962)
Net foreign exchange gain	130	55	451	139	1
Other operating income	123	19	197	2,125	1,784
Other net operating income	546	(1,664)	(743)	1,444	823
Total operating income	**11,598**	**9,407**	**43,153**	**45,165**	**44,987**
Salaries and related expenses	(3,574)	(3,247)	(12,917)	(14,019)	(15,500)
Other operating expenses	(2,278)	(2,445)	(9,829)	(10,469)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(183)	(228)	(679)	(936)	(1,173)
Bank tax	(410)	(359)	(1,588)	(3,528)	(3,281)
Total operating expenses	**(6,445)**	**(6,279)**	**(25,013)**	**(28,952)**	**(32,104)**
Profit before net impairment on financial assets	**5,153**	**3,128**	**18,140**	**16,213**	**12,883**
Net impairment on financial assets	(518)	(3,490)	(8,816)	(3,480)	1,584
Profit (loss) before tax	**4,635**	**(362)**	**9,324**	**12,733**	**14,467**
Income tax expense	(1,036)	(769)	(2,472)	(3,909)	(4,734)
Profit (loss) for the period from continuing operations	**3,599**	**(1,131)**	**6,852**	**8,824**	**9,733**
Discontinued operations, net of income tax	16	(245)	(97)	(370)	912
Profit (loss) for the period	**3,615**	**(1,376)**	**6,755**	**8,454**	**10,645**
Profit (loss) attributable to shareholders of the Bank	3,617	(1,251)	7,061	8,809	11,036
Loss attributable to non-controlling interests	(2)	(125)	(306)	(355)	(391)
Profit (loss) for the period	**3,615**	**(1,376)**	**6,755**	**8,454**	**10,645**
Earnings per share from continuing operations					
Basic and diluted earnings per share attributable to the shareholders of the Bank	0.36	(0.10)	0.72	0.92	1.01

*For the three months ended 31 March 2020, and the years ended 31 December 2020 and 2019, the subsidiary Borgun was classified as discontinued operations.

Consolidated Statement of Financial Position

	As at 31 March	As at 31 December		
	2021	2020	2019	2018
		(ISK in millions)		
Assets				
Cash and balances with Central Bank	88,748	78,948	146,638	135,056
Loans to credit institutions	103,333	89,920	54,376	41,577
Bonds and debt instruments	103,627	128,216	52,870	69,415
Derivatives	2,536	6,647	5,621	4,550
Loans to customers	1,029,415	1,006,717	899,632	846,599
Shares and equity instruments	25,763	14,851	18,426	13,074
Investments in associates	841	775	746	682
Property and equipment	7,191	7,341	9,168	5,271
Intangible assets	3,357	3,478	4,330	5,002
Other assets	17,566	4,125	6,608	7,947
Non-current assets and disposal groups held for sale	2,858	3,173	1,075	1,230
Total assets	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**
Liabilities				
Deposits from Central Bank and credit institutions	31,565	39,758	30,925	15,619
Deposits from customers	698,575	679,455	618,313	578,959
Derivative instruments and short positions	9,533	6,936	6,219	5,521
Debt issued and other borrowed funds	398,225	387,274	306,381	300,976
Subordinated loans	25,259	27,194	22,674	16,216
Tax liabilities	5,947	5,450	7,853	7,150
Other liabilities	30,660	11,920	27,063	29,649
Total liabilities	**1,199,764**	**1,157,987**	**1,019,428**	**954,090**
Equity				
Share capital	10,000	10,000	10,000	10,000
Share premium	55,000	55,000	55,000	55,000
Reserves	6,353	6,181	7,065	6,499
Retained earnings	113,335	113,529	105,569	102,496
Total shareholders' equity	**184,688**	**184,710**	**177,634**	**173,995**
Non-controlling interests	783	1,494	2,428	2,318
Total equity	**185,471**	**186,204**	**180,062**	**176,313**
Total liabilities and equity	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**

Consolidated Statement of Cash Flows

	Three months ended 31 March		Year ended 31 December		
	2021	**2020**	**2020**	**2019**	**2018**
			(ISK in millions)		
Profit (loss) for the period	3,615	(1,376)	6,755	8,454	10,645
Non-cash items included in profit (loss) for the period	4,541	8,612	28,780	24,324	16,061
Changes in operating assets and liabilities	(6,820)	(2,553)	(109,535)	(7,998)	(120,407)
Dividends received	29	12	30	46	55
Income tax and bank tax paid	(1,096)	(1,096)	(6,754)	(6,493)	(7,873)
Net cash (used in) provided by operating activities	**269**	**3,599**	**(80,724)**	**18,333**	**(101,519)**
Net investment in subsidiaries and associates	-	-	(2,176)	-	4,764
-thereof proceeds from disposal of subsidiaries and associates	-	-	2,384	-	4,764
-thereof cash and cash equivalents owned by a subsidiary sold during the period	-	-	(4,560)	-	-
Proceeds from sales of property and equipment	15	8	24	21	15
Purchase of property and equipment	(30)	(351)	(552)	(327)	(611)
Purchase of intangible assets	(19)	(28)	(260)	(246)	(877)
Net cash used in investing activities	**(34)**	**(371)**	**(2,964)**	**(552)**	**3,291**
Proceeds from borrowings	32,683	8,260	80,778	112,105	115,661
Repayment and repurchases of borrowings	(14,840)	(6,027)	(33,673)	(114,708)	(48,475)
Repayment of lease liabilities	(102)	(97)	(390)	(378)	-
Dividends paid	(2,652)	-	-	(5,300)	(13,000)
Subsidiary's capital decrease and share buyback paid to non-controlling interests	(704)	-	-	-	-
Net cash provided by (used in) financing activities	**14,385**	**2,136**	**46,715**	**(8,281)**	**54,186**
Net increase (decrease) in cash and cash equivalents	14,620	5,364	(36,973)	9,500	(44,042)
Effects of foreign exchange rate changes	(54)	177	160	(222)	(193)
Cash and cash equivalents at the beginning of the period	115,668	152,481	152,481	143,203	187,438
Cash and cash equivalents at the end of the period	**130,234**	**158,022**	**115,668**	**152,481**	**143,203**
Reconciliation of cash and cash equivalents					
Cash on hand	3,695	4,367	3,814	4,403	3,095
Cash balances with Central Bank	85,053	118,695	75,134	142,235	131,961
Bank accounts	51,225	37,649	46,269	21,122	25,259
Mandatory reserve, special restricted and pledged balances with Central Bank	(9,739)	(8,828)	(9,549)	(15,279)	(17,112)
Cash and cash equivalents attributable to discontinued operations	-	6,139	-	-	-
Cash and cash equivalents at the end of the period	**130,234**	**158,022**	**115,668**	**152,481**	**143,203**
Depreciation, amortisation and write-offs	345	448	1,765	1,960	1,312
Share of (profit) loss and reversal of impairment of associates	(66)	19	(45)	(64)	(29)
Accrued interest and fair value changes on debt issued and subordinated loans	2,889	2,359	12,621	11,450	10,436
Net impairment on financial assets	556	3,272	9,056	3,568	(1,634)
Foreign exchange gain	(130)	(1)	(387)	(143)	(1)
Net (gain) loss from sales of subsidiaries, property and equipment	(7)	(2)	(427)	17	(1,557)
Unrealised fair value loss recognised in profit or loss	(493)	1,320	1,545	192	406
Discontinued operations, net of income tax	(16)	29	524	125	(912)
Bank tax	410	359	1,588	3,528	3,281
Income tax	1,036	760	2,472	3,682	4,734
Other changes	17	49	68	9	25
Non-cash items included in profit (loss) for the period	**4,541**	**8,612**	**28,780**	**24,324**	**16,061**
Mandatory reserve, special restricted and pledged balances with Central Bank	(190)	6,451	5,730	1,833	454
Loans to credit institutions	(10,283)	(6,169)	(7,725)	(15,268)	767
Bonds and debt instruments	24,063	(13,828)	(73,163)	17,254	(38,740)
Loans to customers	(30,802)	(9,879)	(100,076)	(52,638)	(82,808)
Shares and equity instruments	(11,142)	2,594	(885)	(3,953)	(2,411)
Other assets	(12,615)	(4,656)	(995)	1,644	3,455
Non-current assets and liabilities held for sale	278	(17)	1,168	3	-
Deposits from Central Bank and credit institutions	(7,751)	1,763	7,714	15,232	4,116
Deposits from customers	21,379	16,860	51,984	37,678	4,307
Derivative instruments and short positions	2,890	3,874	8,942	(2,944)	(2,761)
Other liabilities	17,353	454	(2,229)	(6,839)	(6,786)
Changes in operating assets and liabilities	**(6,820)**	**(2,553)**	**(109,535)**	**(7,998)**	**(120,407)**

Certain Other Financial Information

The table below sets forth certain other financial information, including the Non-IFRS Information, as of and for the periods indicated, along with explanatory notes. This section should be read in conjunction with "*Presentation of Financial and Other Information—Presentation of Financial Information—Non-IFRS information*". The Non-IFRS Information does not constitute measurements of performance or liquidity under IFRS or any other generally accepted accounting principles. Investors should not place undue reliance on this Non-IFRS Information and should not consider these measures as: (a) an alternative to profit from operating activities or profit as determined in accordance with IFRS, or as measures of operating performance; (b) an alternative to cash flows from operating, investing or financing activities, as determined in accordance with IFRS, or a measure of the Group's ability to meet cash needs; or (c) an alternative to any other measures of performance under IFRS. These measures are not indicative of the Group's historical operating results, nor are they meant to be predictive of future results. The Bank has presented these supplemental measures because they are used by the Bank to monitor the underlying performance of its business and operations. Since all companies do not calculate these measures in an identical manner, the Group's presentation may not be consistent with similar measures used by other companies. None of this financial information is subject to any audit or review by independent auditors.

	As of and for the three months ended 31 March		As of and for the year ended 31 December		
	2021	2020	2020	2019	2018
Liquidity coverage ratio(1)(**)	172%	177%	196%	155%	172%
Net stable funding ratio(2) (**)	119%	120%	123%	119%	114%
CET1 ratio(3) (**)	19.2%	19.2%	20.1%	19.9%	20.3%
Loan-to-deposit ratio(4)(*)	147%	143%	148%	145%	146%
REA density(5)(*)	68.9%	72.6%	69.4%	73.7%	74.8%
Net interest margin(6)(*)	2.4%	2.8%	2.6%	2.7%	2.9%
Return on equity(7)(*)	7.7%	-3.0%	3.7%	4.8%	6.1%
Cost-to-income ratio(8)(*)	52.0%	62.9%	54.3%	58.8%	66.3%
Total capital ratio(9) (**)	21.9%	21.9%	23.0%	22.4%	22.2%
Deposit yield(10)(*)	0.7%	1.6%	1.2%	2.5%	2.8%
Loan-to-value on mortgages to individuals(11)	65.0%	62.0%	64.0%	62.0%	61.0%
Over-collateralisation(12)	28%	28%	28%	28%	27%
Leverage ratio(13) (**)	12.6%	13.5%	13.6%	14.2%	14.6%
Dividend ratio(14)(*)	–	–	50%	–	50%
Cost of risk(15)(*)	0.20%	1.51%	0.91%	0.39%	-0.20%
Asset encumbrance ratio(16)(**)	18.3%	18.2%	18.7%	18.1%	18.0%
Long term annual credit loss(17)			0.57%		

(*) Indicates Non-IFRS Information which is an alternative performance measure. Alternative Performance Measures, APMs, are financial measures of historical or future financial performance, financial position, or cash flows, other than those defined in the applicable financial reporting framework (IFRS) or in the EU Capital Requirements Regulation and Directive CRR/CRD IV. APMs are used by the Bank when relevant to assess and describe the Bank's financial situation and provide additional relevant information and tools to enable analysis of the Bank's performance. Return on equity provides relevant information on the performance in relation to different investment measurements. The cost-to-income ratio provides information on the Bank's cost efficiency. APMs related to lending provide information on provisions in relation to credit risk. All these measures may not be comparable to similarly titled measures used by other companies.

(**) Indicates Non-IFRS Information required by EU Capital Requirements Regulation No. 575/2013 (CRR).

(1) Liquidity coverage ratio, or LCR, is defined as the quotient of the weighted liquid assets divided by the difference between the weighted cash outflows and the weighted cash inflows, where weighted cash inflows are capped at 75% of weighted cash outflows. For additional information, see the note titled "Liquidity risk" in the Annual Financial Statements. It is defined in accordance with the CRD IV standards as reflected in the Rules on Liquidity Ratio and the Rules on Funding Ratio in Foreign Currencies of the Central Bank of Iceland. See also "*Operating and Financial Review—Liquidity*" and "*Risk Management—Liquidity and Funding Risk*".

(2) Net stable funding ratio, or NSFR, is defined in accordance with the CRD IV standards as reflected in the Rules on Liquidity Ratio and the Rules on Funding Ratio in Foreign Currencies of the Central Bank of Iceland. The ratio measures the proportion of stable funding to long-term assets for a time horizon of over one year. In particular, the NSFR is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities and thus to limit over-reliance on short-term wholesale funding. See also "*Operating and Financial Review—Liquidity*" and "*Risk Management—Liquidity and Funding Risk*".

(3) CET1 ratio is defined as the Common Equity Tier 1 (CET1) capital expressed as a percentage of the total risk exposure amount. The Common Equity Tier 1 capital is defined in accordance with article 84a in Act No. 161/2002 on Financial Undertakings. The total risk exposure amount is defined in accordance with regulation No. 233/2017 on prudential requirements for financial undertakings . For a calculation of the CET1 ratio, see "*Operating and Financial Review—Capital Position*".

(4) Loan-to-deposit ratio is defined as quotient of loans to customers divided by deposits from customers. See also "*Operating and Financial Review—Liquidity*". Loan-to-deposit ratio is an important supplemental measure for securities analysts, investors, and other interested parties to evaluate the Bank's viability to cover withdrawals made by customers and in comparison with other banks.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Loans to customers	1,029,415	923,850	1,006,717	899,632	846,599
Deposits from customers	698,575	647,795	679,455	618,313	578,959
Loan-to-deposit ratio	**147%**	**143%**	**148%**	**145%**	**146%**

(5) REA density is defined as risk exposure amount expressed as a percentage of total assets. For a calculation of REA density, see "*Operating and Financial Review—Capital Position*". The REA density is an important complementary measure reflecting the average risk weight for the Bank's assets when calculating the capital ratio.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
REA	954,712	911,375	933,521	884,550	845,949
Total assets	1,385,235	1,255,691	1,344,191	1,199,490	1,130,403
REA density	**68.9%**	**72.6%**	**69.4%**	**73.7%**	**74.8%**

(6) Net interest margin is defined as net interest income for the period as a percentage of average assets. Average assets are calculated as the average of the opening balance for the applicable period and closing balance for each month of the applicable period. Net interest margin is an important supplemental measure of the Bank's operating performance and it may be used by securities analysts, investors, and other interested parties in the evaluation of the Bank's performance in comparison with other banks. The tables below present net interest margin for the Bank and for Personal Banking, Business Banking and Corporate & Investment Banking.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Net interest income	8,190	8,580	33,371	32,822	31,937
Average assets	1,360,832	1,227,167	1,285,310	1,206,090	1,120,084
Net interest margin	**2.4%**	**2.8%**	**2.6%**	**2.7%**	**2.9%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Net interest income	2,859	2,753	10,749	10,578	9,946
Average assets	439,696	332,523	355,295	317,383	238,729
Net interest margin – Personal Banking	**2.6%**	**3.3%**	**3.0%**	**3.3%**	**4.2%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Net interest income	2,531	2,656	10,536	10,812	9,788
Average assets	235,390	235,938	237,632	233,470	265,830
Net interest margin – Business Banking	**4.3%**	**4.5%**	**4.4%**	**4.6%**	**3.7%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Net interest income	2,111	2,224	8,530	8,397	7,676
Average assets	357,527	345,602	360,690	340,161	302,494
Net interest margin – Corporate & Investment Banking	**2.4%**	**2.6%**	**2.4%**	**2.5%**	**2.5%**

(7) Return on equity is defined as profit for the period as a percentage of average total equity. Average total equity is calculated as the average of the opening balance for the applicable period and closing balance for each month of the applicable period. Return on equity is an important supplemental measure of the Bank's profitability and it may be used by securities analysts, investors, and other interested parties in the evaluation of the Bank's performance in comparison with other banks.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Profit (loss) for the period	3,615	(1,376)	6,755	8,454	10,645
Average total equity	186,690	180,651	181,587	176,967	174,183
Return on equity	**7.7%**	**(3.0)%**	**3.7%**	**4.8%**	**6.1%**

(8) Cost-to-income ratio is calculated as (Administrative expenses + Contribution to the Depositors' and Investors' Guarantee Fund – One-off items) / (Total operating income – One-off items). Cost-to-income ratio is an important supplemental measure of the Bank's cost efficiency and it may be used by securities analysts, investors, and other interested parties in the evaluation of the Bank's performance in comparison with other banks. A one-off item is an income or expense that is nonrecurring in nature and therefore not considered part of the Bank's ongoing business operations. One-off items in 2019 include a settlement of the Bank's claim deriving from the acquisition of Byr savings bank in 2011 amounting to ISK 1,103 million and a reversal of previously expensed contribution to the Depositors' and Investors' Guarantee Fund relating to past changes in the legislation on deposit insurance amounting to ISK 847 million. One-off items in 2018 include net gain from sale of subsidiary amounting to ISK 1,526 million. The tables below present the cost-to-income ratio for the Bank and for Personal Banking, Business Banking and Corporate & Investment Banking

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Salaries and related expenses	3,574	3,247	12,917	14,019	15,500
Other operating expenses	2,278	2,445	9,829	10,469	12,150
Contribution to the Depositors' and Investors' Guarantee Fund	183	228	679	936	1,173
Total expenses	**6,035**	**5,920**	**23,425**	**25,424**	**28,823**
Total operating income	11,598	9,407	43,153	45,165	44,987
One-off items	—	—	—	1,950	1,526
Total income	**11,598**	**9,407**	**43,153**	**43,215**	**43,461**
Cost-to-income ratio	**52.0%**	**62.9%**	**54.3%**	**58.8%**	**66.3%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Salaries and related expenses	595	611	2,416	2,791	2,585
Other operating expenses	601	596	2,584	2,131	2,466
Contribution to the Depositors' and Investors' Guarantee Fund	145	129	482	530	669
Cost allocation	1,212	1,195	4,690	5,606	5,134
Total expenses	**2,553**	**2,531**	**10,172**	**11,058**	**10,854**
Total operating income	3,797	3,578	14,103	15,159	14,511
One-off items	—	—	—	—	—
Total income	**3,797**	**3,578**	**14,103**	**15,159**	**14,511**
Cost-to-income ratio – Personal Banking	**67.2%**	**70.7%**	**72.1%**	**72.9%**	**74.8%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Salaries and related expenses	479	453	1,940	1,993	2,069
Other operating expenses	258	281	1,164	1,184	1,062
Contribution to the Depositors' and Investors' Guarantee Fund	34	75	161	314	395
Cost allocation	812	741	2,967	3,381	2,813
Total expenses	**1,583**	**1,550**	**6,232**	**6,872**	**6,339**
Total operating income	3,063	3,126	12,503	12,553	11,306
One-off items	—	—	—	—	—
Total income	**3,063**	**3,126**	**12,503**	**12,553**	**11,306**
Cost-to-income ratio – Business Banking	**51.7%**	**49.6%**	**49.8%**	**54.7%**	**56.1%**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Salaries and related expenses	429	412	1,583	1,720	1,641
Other operating expenses	215	233	870	660	680
Contribution to the Depositors' and Investors' Guarantee Fund	4	23	35	89	109
Cost allocation	812	805	3,020	3,421	2,660
Total expenses	**1,460**	**1,473**	**5,508**	**5,890**	**5,090**
Total operating income	3,310	3,273	13,527	12,491	11,350
One-off items	—	—	—	—	—
Total income	**3,310**	**3,273**	**13,527**	**12,491**	**11,350**
Cost-to-income ratio – Corporate & Investment Banking	**44.1%**	**45.0%**	**40.7%**	**47.2%**	**44.8%**

(9) Total capital ratio is defined as the own funds of the institution expressed as a percentage of the total risk exposure amount. For a calculation of the total capital ratio, see "*Operating and Financial Review—Capital Position*".

(10) Deposit yield is defined as interest expense from total deposits for the period as a percentage of average total deposits. Average total deposits are calculated as the average of the opening balance for the applicable period and closing balance for each month of the applicable period. See also "*Operating and Financial Review—Funding—Deposit Funding*". Deposit yield is an important supplemental measure for securities analysts, investors, and other interested parties in evaluation of the Bank's funding cost and in comparison with other banks.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Interest expense from total deposits	1,288	2,684	8,436	15,867	16,948
Average total deposits	717,253	659,175	697,609	629,776	599,051
Deposit yield	**0.7%**	**1.6%**	**1.2%**	**2.5%**	**2.8%**

(11) The Loan-to-Value or LTV for a single mortgage is the current net carrying amount of the loan divided by the value of the property. The value of the property is usually taken as the tax value obtained from Registers Iceland but for newly granted mortgages, the purchase price of the property can be used as a valuation in the beginning while it is considered more accurate. For mortgages that are not on the first lien, the cumulative loan to value (CLTV) is the sum of the current carrying amount of the loan under consideration and the outstanding balance of all previous liens, divided by the value of the property. To find the average LTV of a mortgage portfolio, each property is assigned the maximum CLTV value of the Bank's mortgages on that property and that value is weighted with the total carrying amount of the Bank's loans on the property. For the mortgage portfolio, the average LTV is a weighted average of the LTV of individual mortgages where the weights are the total amount each collateral secures.

(12) Over-collateralisation is defined as the ratio of Cash account and loans in the cover pool eligible for calculation exceeding the value of Covered Bonds Issuance. See also "*Operating and Financial Review—Funding—Covered Bonds*".

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Cash account and loans in cover pool	278,860	212,678	236,720	200,314	184,461
Covered bond issuance	218,452	166,666	184,939	156,769	144,932
Over-collateralisation	**128%**	**128%**	**128%**	**128%**	**127%**

(13) Leverage ratio is defined as Tier 1 capital as a ratio of total exposure.

(14) Dividend ratio is defined as dividend paid out as a percentage of total profit. See also "*Shares and Share Capital—Dividends and Dividend Policy*". Dividend ratio is an important information for shareholders, securities analysts, investors, and other interested parties to evaluate the total amount of dividend paid out to shareholders relative to the Bank's profit of the year and in comparison with other banks.

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
	(ISK in millions, except percentages)				
Dividend paid out	—	—	3,400	—	5,300
Profit (loss) for the period	3,615	(1,376)	6,755	8,454	10,645
Dividend ratio	**—**	**—**	**50%**	**—**	**50%**

(15) Cost of risk is defined as the net impairment charge on financial assets in a given period over average loans to customers as a percentage on the basis of gross carrying amount, annualised for 1Q 2021 and 1Q 2020. The cost of risk measure reflects both actual and expected future loss of the credit portfolio.

	Three months ended 31 March		Year ended 31 December		
	2021	**2020**	**2020**	**2019**	**2018**
	(ISK in millions, except percentages)				
Impairment charge	518	3,490	8,816	3,480	(1,584)
Average gross loans to customers	1,035,751	923,570	967,081	882,287	810,105
Cost of risk	**0.20%**	**1.51%**	**0.91%**	**0.39%**	**-0.20%**

(16) Asset encumbrance ratio is defined as the ratio of encumbered assets and collateral received relative to the total assets. See also "*Icelandic Securities Market—Transactions and Ownership Disclosure Requirements*".

(17) Long term annual credit loss (excluding mortgages) is defined as 12 month expected loss for facilities in stage 1 and stage 2, excluding mortgages and the Bank's liquidity portfolio. This is a forward-looking measure that is used to assess the general risk composition of the loan portfolio. Under IFRS 9, all loans are required to carry an impairment allowance of either 12-month expected credit loss (stage 1) or, in case of a significant increase in credit risk since origination, lifetime expected credit loss (stage 2). This impairment allowance is calculated using several different scenarios for the future economic development and the final result is the probability-weighted average of the ECL in these scenarios. For this measure, however, the 12-month expected credit loss is used for both stage 1 and 2 and the effect of future economic development is diversified away in order to convert the measurement from point-in-time to a long term average. Loans in stage 3 are excluded. Residential mortgages and the Bank's liquidity portfolio are also excluded.

OPERATING AND FINANCIAL REVIEW

The following discussion of the financial condition and results of operations of the Bank should be read in conjunction with the Annual Financial Statements, together with the notes thereto and with the information relating to the business of the Bank included elsewhere in this Prospectus. In particular, this section should be read in conjunction with the financial information of the Group as set forth in "Annual Financial Statements" and the other financial information contained elsewhere in this Prospectus, including under "Selected Consolidated Financial, Operating and Other Information" and "Selected Statistical Information."

The following discussion includes forward-looking statements that reflect the current view of the Bank's management and involve risks and uncertainties. The actual results of the Bank could differ materially from those contained in any forward-looking statements as a result of factors discussed below and elsewhere in this Prospectus, particularly in "Risk Factors" and "Presentation of Financial and Other Information—Forward-Looking Statements." Prospective investors should read this Prospectus in its entirety and not just rely upon summarised information set forth in this Operating and Financial Review.

Overview

The Bank is licensed as a commercial bank in Iceland in accordance with item 1 of Article 4(1) of the Financial Undertakings Act and offers comprehensive services to the retail and corporate sectors. The Bank is one of Iceland's three main banks and maintains a strong market share across the spectrum of banking services in the country. The Bank seeks to provide the highest quality services to consumers and corporations, with a focus on building value and retaining a strong sense of social responsibility. The Bank's core values are passion, professionalism and collaboration. 85% of the Bank's employees believe that the Bank is a force of positive change and believe in the strategy of the Bank. Employee satisfaction has been consistently high. For the years ended 31 December 2020, 2019 and 2018, respectively, the Group's net interest income was ISK 33,371 million, ISK 32,822 million and ISK 31,937 million; its net fee and commission income was ISK 10,525 million, ISK 10,899 million and ISK 12,227 million; its operating income was ISK 43,153 million, ISK 45,165 million and ISK 44,987 million; and its profits for the year were ISK 6,755 million, ISK 8,454 million and ISK 10,645 million. As at 31 December 2020, the Group's total assets were ISK 1,344,191 million.

Key Factors Affecting the Group's Business, Financial Position and Results of Operations

The Group's business, financial position and results of operations are affected by a number of factors, some of which are beyond its control. This section, which should be read in conjunction with "*Risk Factors,*" sets forth certain key factors that have affected the Group's business, financial position and results of operations during the periods under review and could affect the Group in the future.

Macroeconomic Environment in Iceland

The macroeconomic environment in Iceland impacts the Bank's financial position and results of operations, particularly with respect to the real estate and deposits markets, exchange rates, interest rates, inflation, and specific regulatory actions related to the economy.

The general performance of the Icelandic economy dictates employment levels, housing prices and levels of personal wealth and disposable income, which affect the Bank's performance. In the period 2011-2019, GDP increased annually in real terms by 3.5% on average. The growth was to a large degree due to a boom in exports, particularly in tourism, which accounted for 35% of export revenues in 2019. However, in 2020, GDP decreased in real terms by 6.6% due to the impact of COVID-19. Declining exports counted for the bulk of the contraction in 2020, falling by 30.5% in real terms while national expenditure contracted by 1.9% in real terms. In particular, some effects of COVID-19 can be seen on the Group's net fee and commission income, which decreased from ISK 10,899 million in 2019 to ISK 10,525 million in 2020, where increases in net fee and commission income attributable to asset management (ISK 157 million), investment banking and brokerage (ISK 34 million) and loans and guarantees (ISK 504 million) were more than offset by decreases attributable to cards and payment processing (ISK 392 million) and other fee and commission income (ISK 677 million).

Investment has recently been close to 20% of GDP, indicating a healthy investment level that facilitates future economic growth. In 2011-2019, total capital formation increased by an average of 9.1% per year, however decreasing by 6.8% in 2020. Business investment in particular has a significant impact on provisions by the

Bank. Business investment increased in real terms by 9.5% per year on average in 2011-2019. In 2020, business investment contracted by 8.7%.

The labour market, which impacts the Bank's operations through the financial conditions of households, has historically been strong and flexible, with low unemployment and robust real wage growth in international context. In 2011-2019, unemployment averaged 4.4%, and the purchasing power of wages increased annually by an average of 4.0%. In 2020, unemployment increased to an average of 7.9% for the year, to a large degree due to the setback in the labour-intensive tourist sector. However, the purchasing power of wages continued increasing in 2020, growing by 3.6% on average from the previous year.

The Central Bank of Iceland's policy rate has a significant impact on the Bank's performance. In the past decade, the general trend for the policy rate has been declining rates. In 2010, the Central Bank of Iceland's rate was 6.8% on average. By 2019, the rate had fallen to 3.8% on average. In 2020, the Central Bank of Iceland cut its policy rate significantly in response to the impact of COVID-19. As at the end of 2020, the main rate was 0.75%, this being the lowest policy rate in Iceland's modern economic history. Along with short-term rates, the general interest rate environment in Iceland has trended lower in the past decade. Benchmark 10-year treasury bond rates fell from an average of 6.3% in 2010 to an average of 2.8% in 2020.

Inflation and the exchange rate of the Icelandic Króna have a significant impact on the Bank's operations and balance sheet. After a long history of high and volatile inflation, the past decade has seen inflation fall to align with the Central Bank of Iceland's 2.5% inflation target, while the year-on-year swing in the inflation rate has fallen drastically. This has enhanced the credibility of the Central Bank of Iceland's monetary policy and increased the pass-through from the bank's monetary policy decision through to the exchange rate, economic activity and inflation rates over the medium term. Since 2015, inflation has on average been 2.3% in Iceland, fluctuating between 0.9% and 4.3% in monthly terms through the end of 2020, although this has increased slightly in 2021. The medium-term trends in inflation are to a large degree dictated by domestic labour costs, residential housing prices and the exchange rate of the ISK.

The trend for residential housing prices has been positive in the past decade as the purchasing power of households has increased, the population has grown, the demand for short-term rentals by tourists has been significant, the supply for such short-term rentals has at times lagged demand and mortgage rates have declined. In 2011-2019, the prices of residential housing rose by 8.5% per year on average due to the aforementioned factors. In 2020, the upward price trend continued despite the economic setback caused by the pandemic, due to the healthy balance sheets of the majority of Icelandic households and a further decline in mortgage rates.

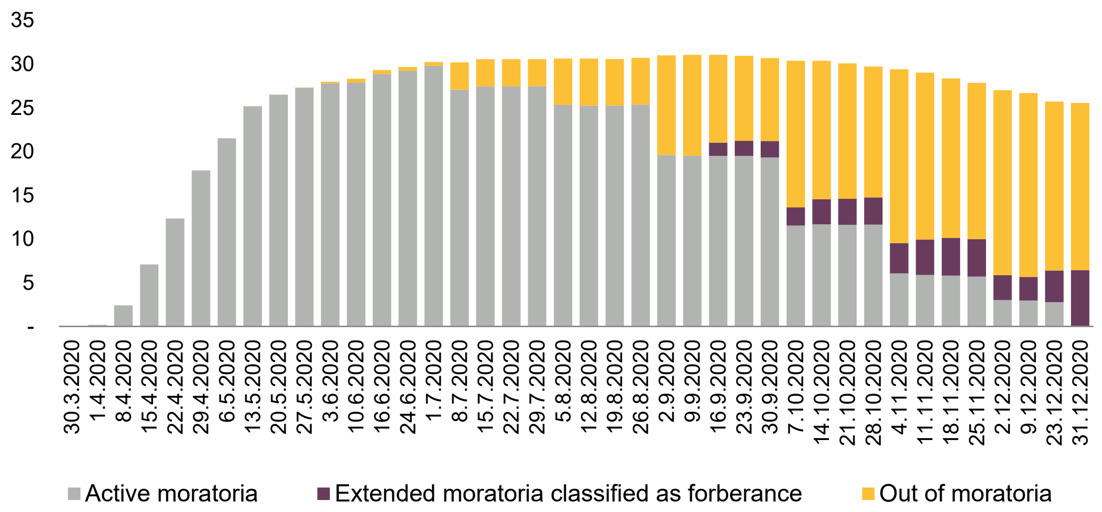
The ISK affects the Bank both directly and through its impact on inflation, purchasing power, international competitiveness of the export sector, and the relative value of ISK and foreign exchange assets economy-wide. As the external debt profile of the Icelandic economy has improved, the Central Bank of Iceland's foreign exchange reserves have increased, and the effectiveness of economic policy has increased, and the changes in the ISK exchange rate have become better correlated with underlying fundamentals, such as GDP growth, export trends and interest rate differentials. After its appreciation from 2015 to 2017, the ISK depreciated gradually in 2018-2019 as export growth slowed. In 2020, the ISK depreciated sharply when the pandemic hit services exports before stabilising at exchange rates broadly around 10% lower (in foreign exchange terms) than in the previous year.

Impact of the COVID-19 Pandemic on the Bank's Loan Portfolio

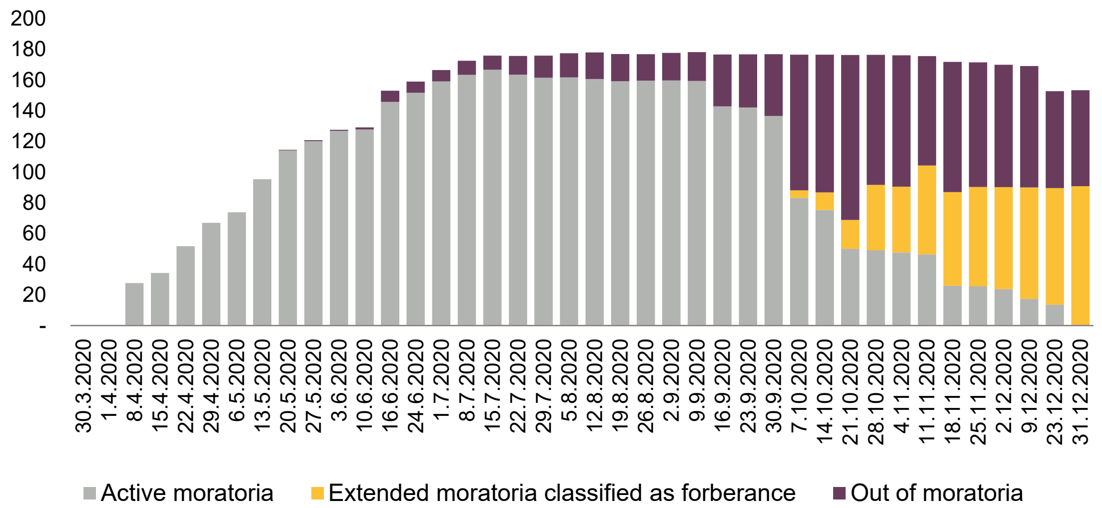
The COVID-19 moratorium in 2020 represented an important first support measure for customers affected by the pandemic, primarily in tourism-related sectors. The Bank entered into an agreement with other lenders in Iceland to provide a moratorium for corporate and household customers, uniformly executed across institutions. In accordance with guidelines from the European Banking Authority and the Central Bank of Iceland, moratoria of this kind do not trigger forbearance, but further extensions of moratoria, which may be granted on a case-by-case basis, are classified as forbearance.

The graphs below demonstrate the scope of the Bank's loans subject to the COVID-19 moratorium, along with extended moratoria classified as forbearance.

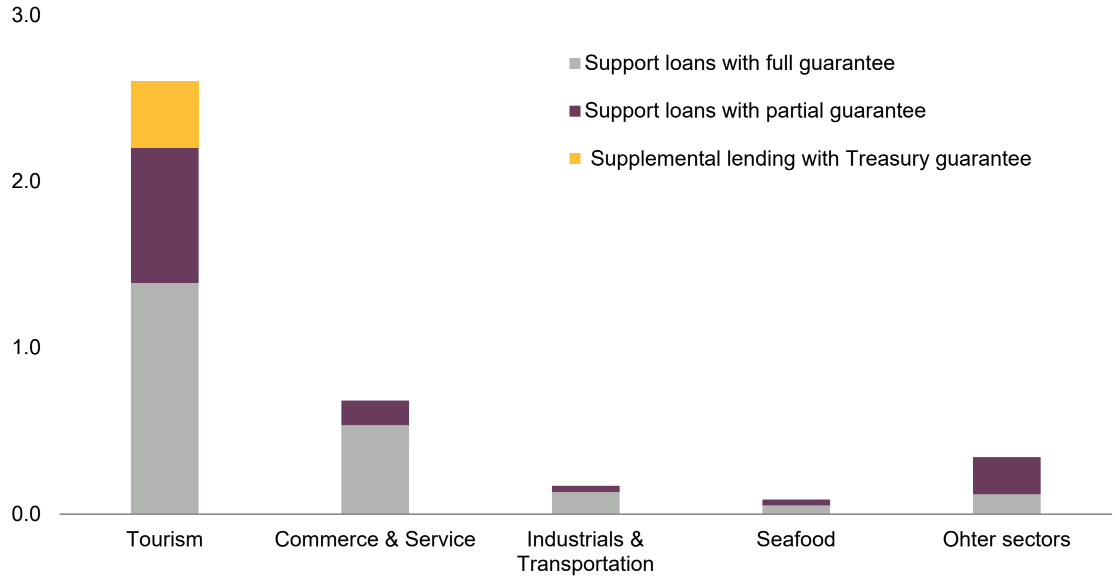
Loans to individuals granted COVID-19 moratorium
Gross carrying amount, ISK in billions, weekly development



Loans to companies granted COVID-19 moratorium
Gross carrying amount, ISK in billions, weekly development



Support loans and supplemental lending with Treasury guarantees
Gross carrying amount, ISK in billions, by sector



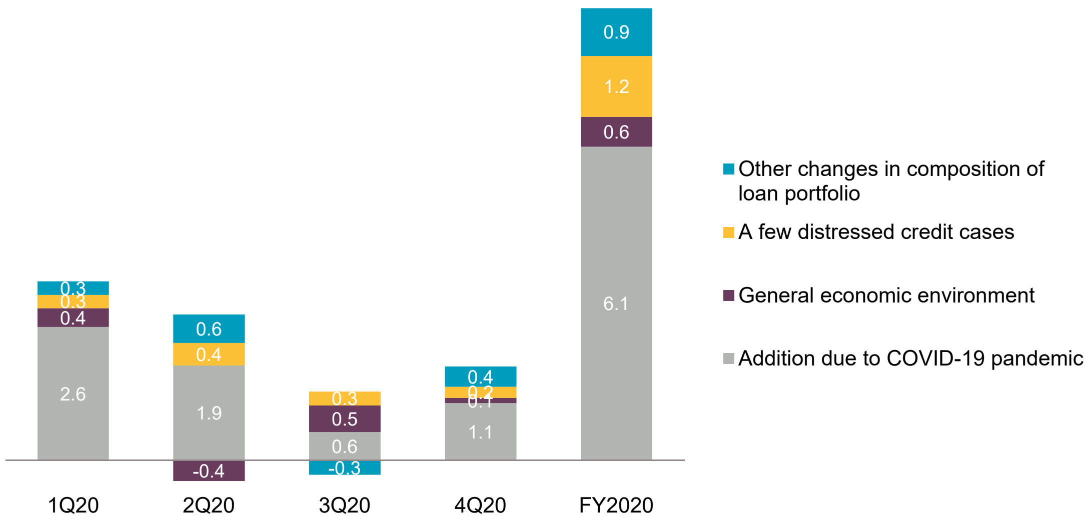
By the end of 2020, 11.1% of the Bank's gross performing loan book (not in Stage 3) was classified as in forbearance, up from 2.9% at the end of the third quarter of 2020. The increase was partly due to extension of moratoria that were granted in the fourth quarter of 2020 to companies in the tourism sector, representing approximately 5% of the Bank's loan portfolio. Loans on which extended moratoria have been granted are primarily with collateral in residential or commercial real estate. The extended moratoria are expected to last until mid-2021, and if the pandemic has not subsided by that time, further measures will be explored.

In addition to application of moratoria, in response to COVID-19, the Icelandic government offered guarantees, full or partial, on new bank loans to companies whose revenues had fallen by at least 40% as a result of COVID-19. The support loans were available to small and medium-sized companies with a 100% government guarantee principal of up to ISK 10 million and an 85% government guarantee for additional principal of up to ISK 40 million. The supplemental lending was targeted at larger companies with a 70% government guarantee. The Bank provided ISK 3.7 billion of government guaranteed loans in 2020, approximately 60% of which is subject to a full government guarantee.

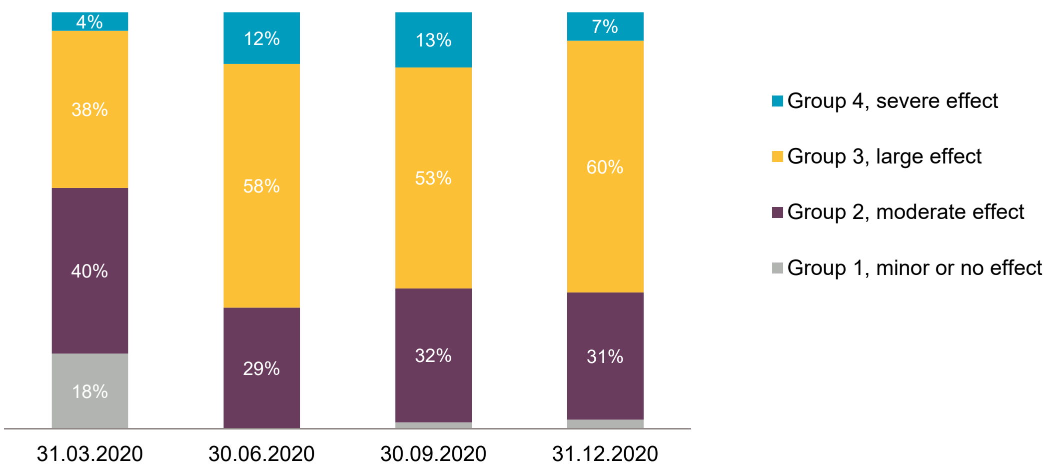
COVID-19 has led to additional impairment allowance in 2020. The impairment model of IFRS 9 is forward-looking and reflects a probability-weighted average of possible outcomes. In addition to a base forecast, scaling factors are produced for a good case and a bad case, and for COVID-19, the Bank set probability weights at 15% (good), 55% (base) and 30% (bad) as at 31 December 2020. On the basis of these models, the net impairment charge over loans to customers was 0.18% for the fourth quarter of 2020 and 0.91% for the full year 2020, and net impairment charges amounted to ISK 8.8 billion in 2020, of which ISK 6.1 billion related to loans to the tourism sector that were transferred to Stage 2 with an increased impairment allowance. Of this amount, ISK 4.3 billion arose in the Business Banking division and ISK 1.8 billion arose in the Corporate & Investment Banking division. This impairment corresponds to corresponding impacts on cost of risk, which amounted to 91 basis points for 2020, of which 63 basis points related to COVID-19 impairments, 182 basis points attributable to Business Banking and 52 basis points attributable to Corporate & Investment Banking.

The graphs below present the net impairment on financial assets, along with the impact of COVID-19, as well as the exposure to the tourism sector in particular, for 2020.

Net impairment on financial assets
ISK in billions, by period



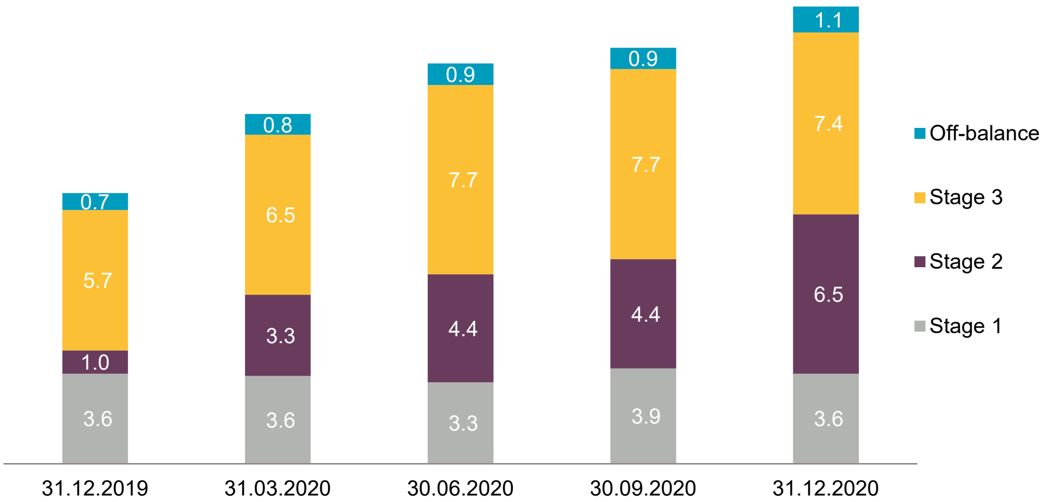
Exposure to tourism by effect of COVID-19 crisis
Net carrying amount, a proportion of approximately ISK 100 billion



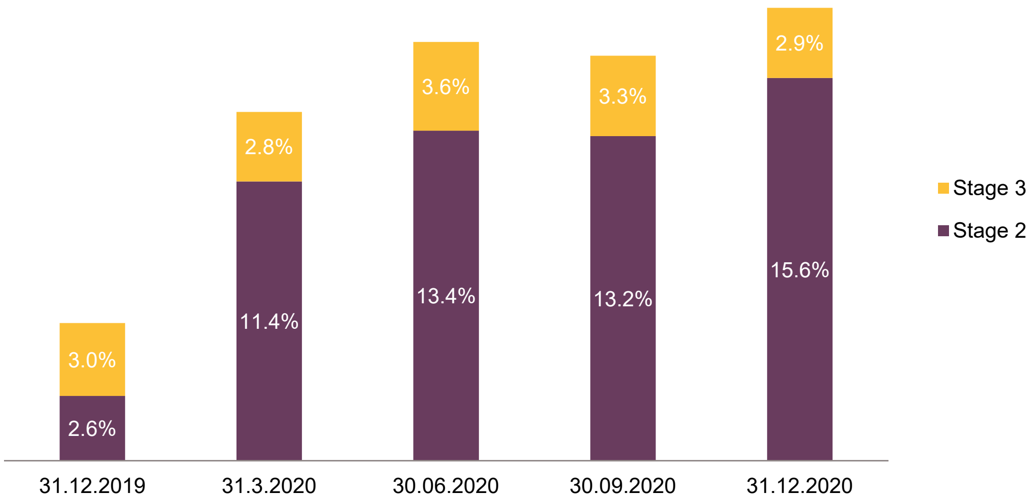
To account for the uncertainty in the operating environment of companies in the tourism sector, not reflected in their current risk class, they are classified into four groups based on an assessment of vulnerability to when the pandemic subsides. Groups 2 – 4 were transferred to Stage 2 and carry a lifetime expected credit loss, and an overlay factor was applied to the expected credit loss, comparable to an increase in up to three risk classes. A higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios.

The loans to the tourism sector were hardest hit and fully transferred to Stage 2, but Stage 3 had not yet increased as at 31 December 2020, as indicated in the graphs below.

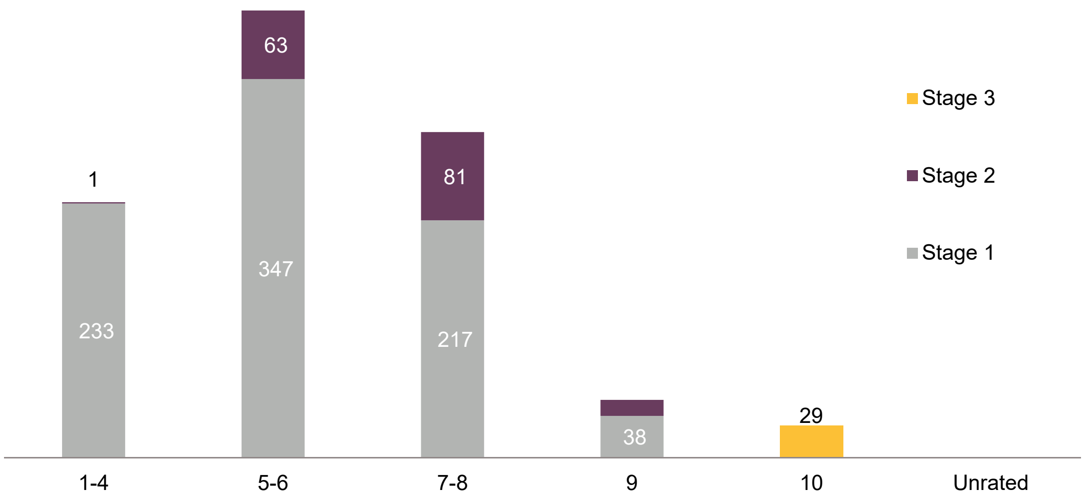
Loans to customers and off-balance sheet items
Impairment allowance account, ISK in billions



Loans to customers: Stage 2 and Stage 3
Development of gross carrying amount as ratio

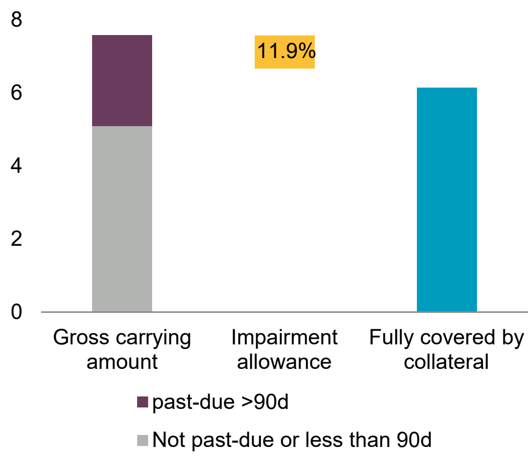


Loans to customers: Gross carrying amount
Risk class and impairment stage as at 31 December 2020, ISK in billions

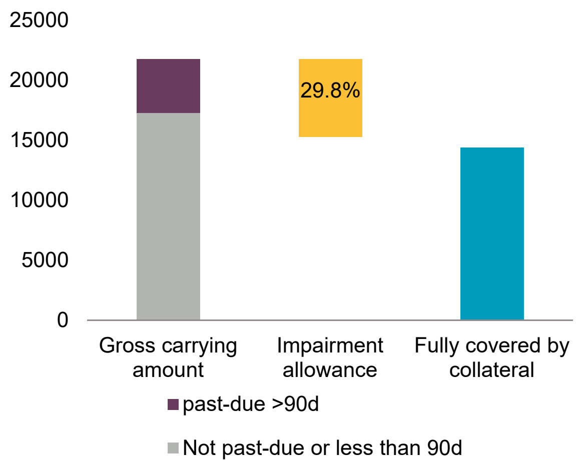


Loans to customers in Stage 3, impairment and collateral
By customer and days past due as at 31 December 2020

Individuals (ISK in billions)



Companies (ISK in millions)



Proportion of Net Fee and Commission Income

The Group targets to increase the proportion of its operating income attributable to net fee and commission income across each of its operating divisions. During the periods under review, the Corporate & Investment Banking and Personal Banking divisions were the two largest contributors to fee and commission income, and this trend is expected to continue as there is likely to be a further margin increase on loans driven by low interest rates and stable market conditions.

Net fee and commission income is primarily driven by transaction volumes, particularly for credit and debit cards, but also for fees for the provisioning of loans and guarantees. Asset management services (including portfolio management and investment advice) and brokerage fees are also a primary fee and commission income for the Group. To a lesser degree, investment banking services, including corporate finance advisory, collection and payment services, and other services are primary fee and commission income for the Group. Net fee and commission income is impacted by economic developments in general (i.e., fewer payments and fewer fees overall as a result of lower economic activity) and the performance of capital markets in particular (lower numbers and volumes of transactions, resulting in decreased transaction and asset management fees). However, transaction fees benefit from volatility, even if markets go down.

Net Interest Income, Net Interest Margin and Funding Mix

The Group's ability to increase net interest income for a given period is influenced by the margins it can generate on its lending, the margins paid on its deposits and the interest on its allocated equity. Margins are primarily driven by the rates that the Group charges on its lending relative to the cost of funding. The Group's principal lending activities are loans to customers (mortgage loans and other secured and unsecured loans to individual and corporate customers, primarily credit cards and overdraft facilities). Its principal funding activities occur through deposits and issuances of debt under the Group's GMTN programme and the Group's covered bond programme.

The Group uses net interest income over average assets to calculate its net interest margin. The average assets are calculated using month-end figures for a given period and the prior year-end figures. The Group's net interest income (and, consequently, net interest margin) depends on, among other things, the interest income that the Group earns on its lending, which in turn depends on the rates it charges on its loans and the upfront fees it charges to its borrowers, which are included in interest income. Net interest margin has decreased during the periods under review, amounting to 2.6%, 2.7% and 2.9% for the years ended 31 December 2020, 2019 and 2018, respectively. This compression in the Bank's net interest margin was mainly due to general pressure on deposit margins as market rates have been decreasing over the period. The Group expects a steady year-on-year increase in respect of its net interest margin through to 2024 as there is a new focus on capital release after years of over-capitalisation in the market. The net interest margin on deposits is also expected to gradually increase over this period in line with an increase in policy rates.

The cost of the Group's liabilities depends on the rate of interest paid on its sources of funding. Changes in the cost of deposits or other borrowings could have a significant impact on the Group's net interest income, net interest margin and profitability. The composition of the Group's funding has changed over the last few years, as the portion of market funding has increased while the portion of funding through customer deposits has decreased. The Group's loan portfolio reflects its broad offering and is supplemented by a strong liquidity portfolio, a consistent factor in the Group's balance sheet management. All of the Group's liquidity ratios are above regulatory requirements and its own internal targets.

The Group is exposed to inflation risk, since assets linked to the CPI exceed liabilities linked to the CPI. The net carrying amount of all CPI-linked assets and liabilities changes according to changes in the CPI at any given time, and all changes in the CPI affect the Group's profit and loss through interest income. The CPI imbalances have, however, been moderate, and thus the low inflation in Iceland since 2013 has not had a significant impact on the Group's reported net interest margin. See "*—Funding.*"

The Group has significant CPI-linked assets and liabilities. As at 31 December 2020, CPI-linked assets amounted to ISK 272,746 million and CPI-linked liabilities amounted to ISK 246,565 million. Accordingly, after netting out the CPI-linked assets against the CPI-linked liabilities, the CPI-linked balance amounted to net assets of ISK 26,181 million as at 31 December 2020, as compared to ISK 20,660 million as at 31 December 2019. The impact of such imbalance between the CPI-linked assets and liabilities on the financial statements of the Group depends on the level of inflation in Iceland and changes in the CPI. The impact is reflected in net interest income in the Group's consolidated income statement. In general, an increase of 1.0% in the rate of inflation in Iceland results in a corresponding increase of 1.0% of the net imbalance reflected in net interest income.

Cost and Efficiency Management

During the periods under review, the Bank has sought to reduce its administrative expenses, mainly through the streamlining of processes and the organisational structure, increased automisation, the merging and closing of branches, the replacement of legacy systems, and a product-focused approach to digital development. During the periods under review, this has reflected the following:

- The drop in administrative expenses in 2020 is mainly due to a decrease in salary costs as a result of employee reductions in 2019.
- The reduction in other expenses in 2020 was primarily due to an overall reduction in the Bank's cost base, partly due to COVID-19.

- A significant share of administrative expenses sits in support divisions and is allocated to business divisions through cost allocations in division reporting.
- The number of employees has consistently decreased over the past few years. However, there was a small increase in the number of employees as at 31 December 2020 due to additional hiring to support strong growth in the mortgage book.

Regulatory Developments

The Group is subject to regulation at both local and international levels. Regulations are subject to constant change, and this environment has affected, and will continue to affect, the Group's results of operations in a number of ways. Principal European regulations that have had or could have an impact on the Group's results of operations include the Basel III framework, implemented through the CRD IV and CRD V, the CRR and CRR II, the BRRD and MiFID 2. Given the Group's small size relative to other financial services providers in Europe, its compliance costs relative to the size of its overall operations could be high.

See "*Regulatory Overview,*" "*Risk Factors—Legal and Regulatory Risk,*" "*Risk Factors—Risks Relating to Business and Industry—The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities,*" and "*Risk Factors—Risks Relating to the Offering and the Offer Shares—Recovery and resolution regimes may affect the rights and remedies of holders of the Offer Shares.*"

The key regulatory developments relating to the Group's financial position and results of operations during the periods under review are summarised below.

Bank Levy

The Bank Levy is an annual levy mandated by Icelandic law under which the Group must currently pay a tax on total liabilities, as determined for tax purposes (excluding tax liabilities), in excess of ISK 50.0 billion. Therefore, as the Group's funding liabilities increase, the impact of the Bank Levy increases correspondingly, which affects the Group's earnings before tax. Non-financial subsidiaries of the Group are exempt from this tax. The Bank Levy was 0.145% for the year ended 31 December 2020 and 0.376% for the years ended 31 December 2019 and 2018. See "*Risk Factors—Risks Relating to Business and Industry—The Bank is subject to additional taxes beyond corporate income tax, which impose costs and competitive disadvantages.*"

Acquisitions and Disposals

Borgun

A formal sale process of the Bank's subsidiary Borgun began early in 2019, as was announced by the Bank on 11 January 2019. On 11 March 2020, the Bank signed an agreement to sell its 63.47% stake in Borgun to SaltPay Co Ltd, subject to the approval of the FSA. The sale was concluded on 7 July 2020.

Before the sale, Borgun was classified as a disposal group held for sale, in accordance with IFRS 5 - Non-current assets and disposal groups held for sale, resulting in a change in the presentation of the Bank's financials. As a result, the comparative figures in the consolidated income statement for the year 2019 have been restated in the 2020 Annual Financial Statements.

The following table shows restated consolidated income statement for the year 2018, and other key information, if Borgun had been classified as a disposal group held for sale in 2018.

	2018 published accounts	Borgun hf. reclassified	2018 restated accounts
		(ISK in millions)	
Interest income	61,675	(1,042)	60,633
Interest expense	(29,738)	24	(29,714)
Net interest income	**31,937**	**(1,018)**	**30,919**
Fee and commission income	19,853	(8,470)	11,383
Fee and commission expense	(7,626)	6,666	(960)
Net fee and commission income	**12,227**	**(1,804)**	**10,423**
Net financial expense	(962)	(18)	(980)
Net foreign exchange gain	1	20	21
Other operating income	1,784	7	1,791
Other net operating income	823	9	832
Total operating income	**44,987**	**(2,813)**	**42,174**
Salaries and related expenses	(15,500)	2,072	(13,428)
Other operating expenses	(12,150)	1,324	(10,826)
Contribution to the Depositors' and Investors' Guarantee Fund	(1,173)	-	(1,173)
Bank tax	(3,281)	-	(3,281)
Total operating expenses	**(32,104)**	**3,396**	**(28,708)**
Profit before net impairment on financial assets	**12,883**	**583**	**13,466**
Net impairment on financial assets	1,584	76	1,660
Profit (loss) before tax	**14,467**	**659**	**15,126**
Income tax expense	(4,734)	(274)	(5,008)
Profit (loss) for the year from continuing operations	**9,733**	**385**	**10,118**
Discontinued operations, net of income tax	912	(385)	527
Profit for the year	**10,645**	**-**	**10,645**

The cost to income ratio for 2018 based on the published accounts was 66.3%, as compared to 62.6% based on the 2018 restated accounts. The net interest margin for 2018 based on the published accounts was 2.9%, as compared to 2.8% based on the 2018 restated accounts. The number of FTEs at Borgun as at 31 December 2018 was 207.

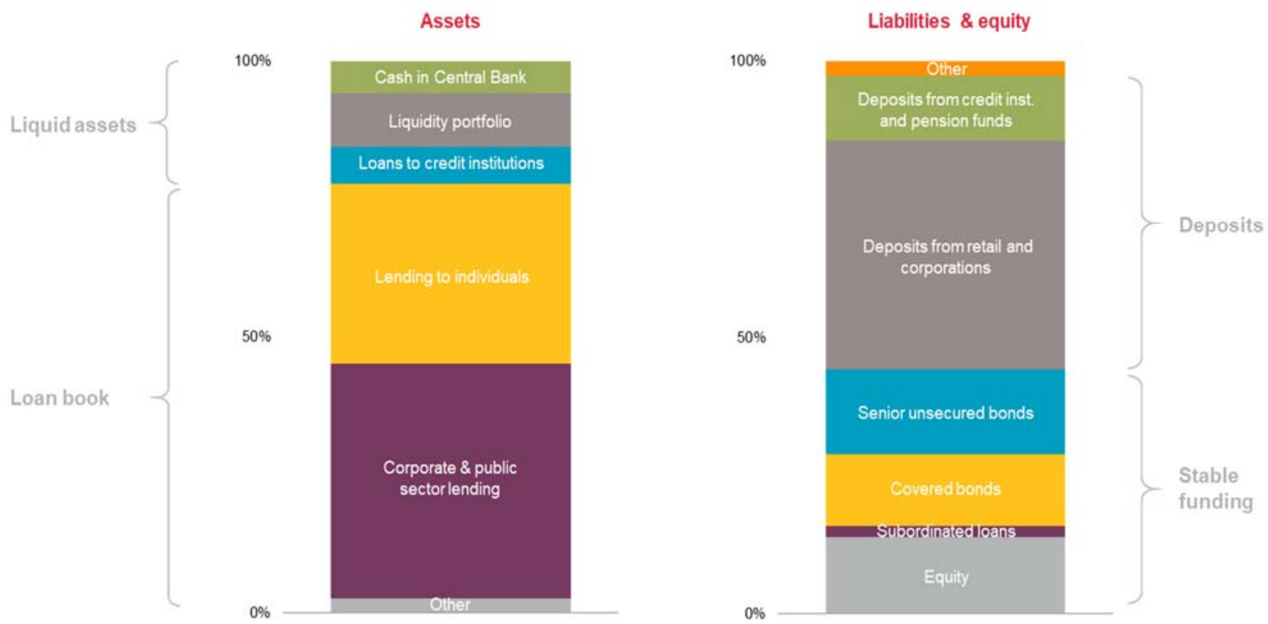
See "*Risk Factors—Risks Relating to Business and Industry—The Bank could incur unforeseen liabilities from prior and future acquisitions and disposals.*"

Growth of Customer Loan Portfolio and Impairment Losses

The Group's ability to increase the volume of loans it extends to customers has been an important factor contributing to growth in net interest income during the periods under review. The Group's customer loan portfolio has increased from ISK 846,599 million as at 31 December 2018 to ISK 899,632 million as at 31 December 2019 and ISK 1,006,717 million as at 31 December 2020. This has been driven in part by a sharp decrease in domestic interest rates.

The customer loan portfolio covers lending in the Personal Banking division (to individuals), the Business Banking division (to SMEs) and the Corporate & Investment Banking division (to larger corporates), with Personal Banking accounting for 41.7% of the customer loan portfolio, Business Banking accounting for 23.1% and Corporate & Investment Banking accounting for 35.2% of the customer loan portfolio as at 31 December 2020. Exposure to countries other than Iceland amounted to ISK 136 billion as at 31 December 2020. This exposure relates mainly to the management of the Bank's foreign liquidity reserves. The Bank has no retail lending activities outside of Iceland but maintains a modestly sized portfolio of lending to companies in the United States, Canada and Norway within its North Atlantic strategy. The exposure to companies within this portfolio was ISK 28 billion as at 31 December 2020. In terms of collateral, as at 31 December 2020, 84.7% of the customer loan portfolio was collateralised and 85.5% of loans to individuals were collateralised. The customer loan portfolio is also highly concentrated in Icelandic borrowers, albeit spread relatively evenly across individuals and companies and, with respect to companies, with a diverse spread across a range of industry sectors.

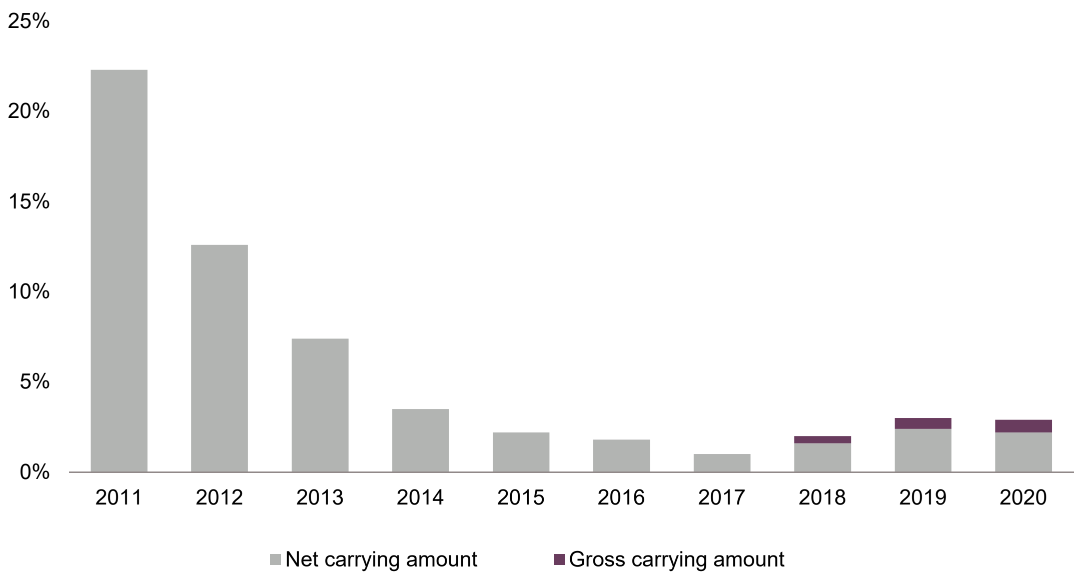
The graphs below present the Bank's balance sheet composition as at 31 December 2020.



The Bank's definition of default has been updated so that it satisfies the requirements in the definition of Stage 3 according to IFRS 9, the definition of default according to article 178 of CRR and the definition of non-performing exposure used in FINREP. Obligors are considered to be in default according to the current definition if, (a) in the opinion of the Bank it is unlikely that the obligor will fulfil the terms of their contract or (b) the obligor is more than 90 days past due on a material credit obligation. Defaults are defined on the obligor level rather than the facility level.

As at 31 December 2020, 2.9% of the customer loan portfolio was classified as non-performing based on the gross carrying amount (3.0% as at 31 December 2019 and 2.0% as at 31 December 2018), and the Group's impairment allowance on its customer loan portfolio amounted to 1.7% (1.1% as at 31 December 2019 and 0.9% as at 31 December 2018) of the total gross amount of the portfolio. As at 31 December 2020, the value of collateral that the Group holds relating to credit-impaired loans amounted to ISK 20,546 million, or 70.2%, of the aggregate carrying amount of the non-performing loans (ISK 20,590 million as at 31 December 2019 (75.4%) and ISK 12,206 million as at 31 December 2018 (70.5%)).

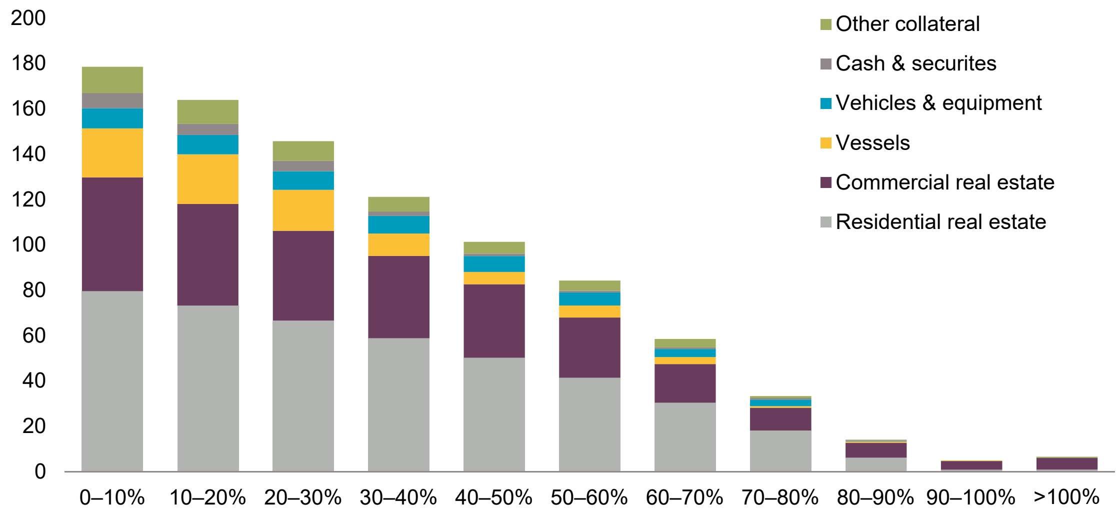
The quality of the Bank's balance sheet has improved dramatically since 2011, as demonstrated in the graph below, which shows non-performing loans as against total loans to customers.



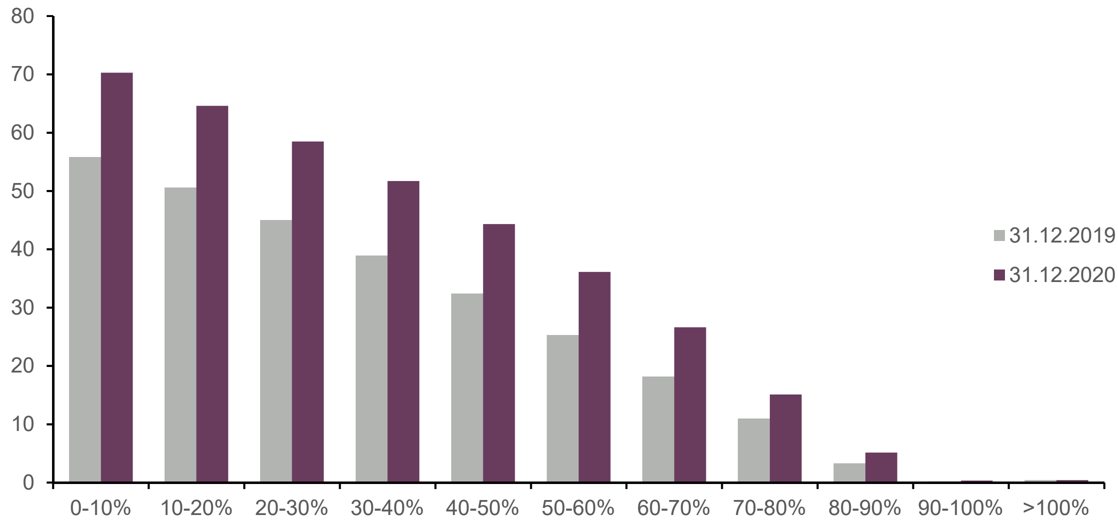
Positive developments reflect favourable economic conditions, prudence in lending operations and a successful restructuring of the Bank's loan portfolio over that period. In particular, the credit quality within the mortgage loans portfolio has improved, through amortisation and increasing housing prices. Overall mortgage lending volumes have increased, with mortgage loans rising from ISK 249,296 million as at 31 December 2018, to ISK 281,499 million as at 31 December 2019, and to ISK 377,155 million as at 31 December 2020. The percentage of loans to individuals (mostly mortgage loans) that are classified as non-performing has increased from 2.1% as at 31 December 2018 to 2.5% as at 31 December 2019 and then decreased to 1.7% as at 31 December 2020. The average LTV for mortgages was 64% as at 31 December 2020, compared to 62% as at 31 December 2019 and 61% as at 31 December 2018. The increase is due to new lending.

The graphs below present the Bank's LTV distribution as at 31 December 2020.

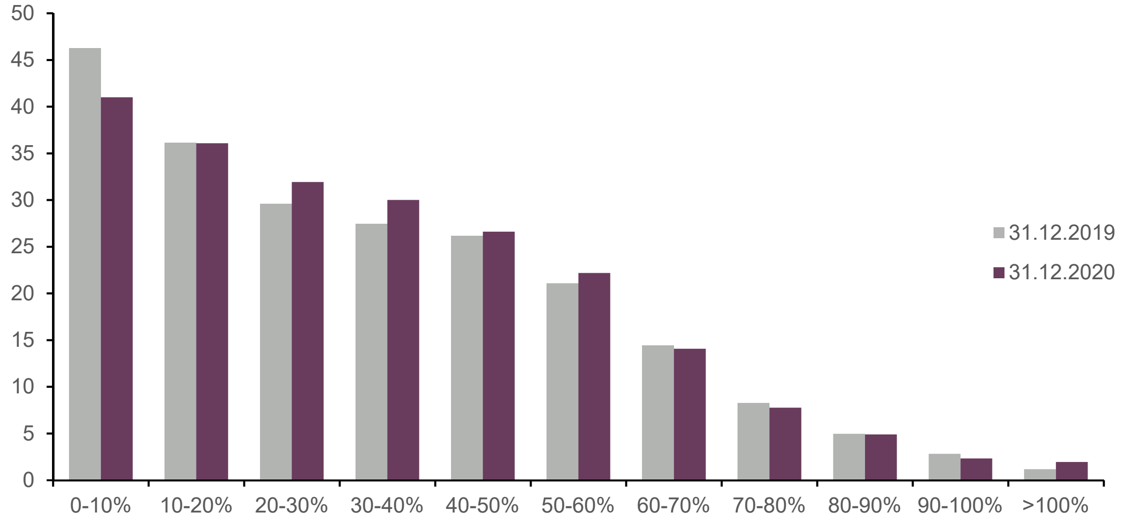
LTV distribution by underlying asset class
ISK in billions, by type of underlying asset as at 31 December 2020



LTV distribution of mortgages to individuals
ISK in billions



LTV distribution of loans secured by commercial real estate
ISK in billions



Total impairment allowances of ISK 18,699 million have been recorded as at 31 December 2020, which included ISK 17,644 million for on-balance sheet items (1.5% of the total gross carrying amount of financial assets) and ISK 1,055 million for off-balance sheet items (0.7% of the off-balance sheet exposure). This was an increase from 31 December 2019, where the total impairment allowances were ISK 11,156 million. This included ISK 10,467 million for on-balance sheet items (0.95% of the total gross carrying amount of financial assets) and ISK 689 million for off-balance sheet items (0.5% of the off-balance sheet exposure). As at 31 December 2018, the total impairment allowances were ISK 8,882 million. This included ISK 8,246 million for on-balance sheet items (0.8% of the total carrying amount of financial assets) and ISK 636 million for off-balance sheet items (0.4% of the off-balance sheet exposure).

For Stage 3, where assets are credit impaired according to the Group's assessments, the total impairment allowance was ISK 7,612 million as at 31 December 2020 (40.7% of the total impairment allowance). As at 31 December 2019, there was an allowance of ISK 6,017 million recorded in Stage 3 (53.9% of the total impairment allowance) and ISK 3,856 million as at 31 December 2018 (43.4% of the total impairment allowance).

The net impairment on financial assets was ISK 8,816 million in 2020, which included write-offs and recoveries of amounts previously written-off. Net impairment on financial assets was ISK 3,480 million in 2019 and a positive amount of ISK 1,584 million in 2018.

The focus of the Bank is to reduce the expected credit loss toward the level of its Nordic peers. However, as at the date of this Prospectus, the Bank believes that its expected credit loss levels will most likely remain slightly higher, given that its Nordic peers benefit from a higher interest rate environment and more unstable currencies in their respective economies. The Bank's strategy to mitigate these Iceland-specific issues will be on maintaining adequate collateralisation and close relationships with customers, allowing improved lending practices and early intervention, should customers face financial challenges.

Recent Developments

The Group's trading performance since 31 March 2021 has exceeded the Bank's expectations. Net interest income in April was comparable to previous months. The Bank's loan book has grown notably in April, reflecting growth in lending to corporates and continuous growth in mortgages. The cost base has followed trends observed in the three months ended 31 March 2021. Loan impairments were positive in April 2021, based on management accounts, and first draft management account numbers for impairments in May 2021 indicate positive impairments in that month. The near term outlook for impairments is favourable if the pick-up in tourism and in the economy follows current trends. It should however be noted that due to the forward looking nature of the IFRS 9 accounting standard for impairments, adverse movements in the economy and for specific borrowers can have a rapid negative impact on the accounts. Furthermore, the ROE for April was in excess of disclosed financial targets, based on unaudited management accounts. In May 2021, the Central Bank of Iceland announced an increase in its policy rates from 0.75% to 1.0%. The Bank has adjusted its deposits and lending rate, taking this decision into account, and expects that this will have a positive impact on net interest income. In addition, since 31 March 2021:

- the Bank has decided to donate a part of its art collection to one or more domestic museums. In total, around 200 pieces of art will be donated. Subject to decisions on the exact accounting principles for the Bank's art holdings, the donation may lead to insignificant expenses or revenues in the Bank's income statement;
- the Bank has been in discussions with the Icelandic Government on the potential acquisition of the Icelandic Government on Auðkenni hf. ("**Auðkenni**"), currently an associated company in the Bank's financial statements. In parallel the Icelandic Government is in comparable discussions with all other shareholders of Auðkenni. Although still uncertain, it is assumed that these discussions will result in a sale of shares of Auðkenni. The Bank believes this will not have a material impact on its operations or financials;
- following a regular review of the Bank's LCR measurement methodology, the Bank has identified certain issues where more than one interpretation of the Central Bank of Iceland's LCR rules is plausible, resulting in different results for the LCR at each point in time. The Bank has shared its observations with the Central Bank of Iceland and is expecting guidance shortly, which may result in a change in the Bank's measurement methodology. The change, if implemented and other things held constant, would result in a higher LCR ratio; and
- a legislation change is being discussed in the parliament which, should it be approved as currently proposed, would provide for tax deductibility of interest on AT1 instruments. Accordingly and subject to reviewing the final legislation and ongoing market conditions, the Bank may explore undertaking an AT1 issuance within a short period of time.

Further, the regular annual SREP process is ongoing with the FSA which will result in a regular revision of the overall capital requirements for the Bank. The Bank assumes that draft results will be presented to the Bank mid-June 2021 and a final decision by the end of June 2021. The Pillar 2-R requirements are expected to increase temporarily as a result of COVID-19. Based on the Bank's own assessment (ICAAP), the increase should be less than the reduction of the counter-cyclical buffer from 2% to 0%. The Central Bank of Iceland will decide on if and how the capital requirements for the Icelandic banks are made public. The Bank has disclosed the SREP capital requirement through its Annual Financial Statements and the Pillar III report.

Other than as described above, there has been no significant change in the financial position or performance of the Group since 31 March 2021, the end of the last financial period for which financial information was prepared.

Financial Position and Results of Operations

Consolidated Statement of Financial Position

	As at 31 March	**As at 31 December**		
	2021	**2020**	**2019**	**2018**
		(ISK in millions)		
Assets				
Cash and balances with Central Bank	88,748	78,948	146,638	135,056
Loans to credit institutions	103,333	89,920	54,376	41,577
Bonds and debt instruments	103,627	128,216	52,870	69,415
Derivatives	2,536	6,647	5,621	4,550
Loans to customers	1,029,415	1,006,717	899,632	846,599
Shares and equity instruments	25,763	14,851	18,426	13,074
Investments in associates	841	775	746	682
Property and equipment	7,191	7,341	9,168	5,271
Intangible assets	3,357	3,478	4,330	5,002
Other assets	17,566	4,125	6,608	7,947
Non-current assets and disposal groups held for sale	2,858	3,173	1,075	1,230
Total assets	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**
Liabilities				
Deposits from Central Bank and credit institutions	31,565	39,758	30,925	15,619
Deposits from customers	698,575	679,455	618,313	578,959

Derivative instruments and short positions	9,533	6,936	6,219	5,521
Debt issued and other borrowed funds	398,225	387,274	306,381	300,976
Subordinated loans	25,259	27,194	22,674	16,216
Tax liabilities	5,947	5,450	7,853	7,150
Other liabilities	30,660	11,920	27,063	29,649
Total liabilities	**1,199,764**	**1,157,987**	**1,019,428**	**954,090**
Equity				
Share capital	10,000	10,000	10,000	10,000
Share premium	55,000	55,000	55,000	55,000
Reserves	6,353	6,181	7,065	6,499
Retained earnings	113,335	113,529	105,569	102,496
Total shareholders' equity	**184,688**	**184,710**	**177,634**	**173,995**
Non-controlling interests	783	1,494	2,428	2,318
Total equity	**185,471**	**186,204**	**180,062**	**176,313**
Total liabilities and equity	**1,385,235**	**1,344,191**	**1,199,490**	**1,130,403**

Explanation of Selected Line Items from the Consolidated Statement of Financial Position

Cash and Balances with Central Bank

Cash and balances include balances held with the Central Bank of Iceland with less than three months' maturity, including cash and balances held for statutory reserve purposes, balances subject to special restrictions and balances pledged as collateral to the Central Bank of Iceland. Cash in hand is also included. Cash and cash equivalents are carried at amortised cost in the statement of financial position, and the expected credit loss at the reporting date is considered low.

Loans to Credit Institutions

Loans to credit institutions include bank accounts, money market loans and other loans. These assets are recognised at amortised cost using the effective interest rate method, less any provision for impairment.

Financial Instruments

The Group's financial instruments include bonds and debt instruments, shares and equity instruments with variable income, derivatives and securities used for economic hedging, and shares classified as non-current assets held for sale. The Group uses derivatives to reduce exposure to various risks. Derivatives held for trading or for other purposes are insignificant. The Group undertakes the following types of derivative financial instruments transactions: (i) forward contracts for foreign exchange and securities (equities and bonds), (ii) foreign exchange and interest rate swaps and (iii) options for foreign exchange. The Group's financial instrument transactions are entered into for the purpose of eliminating risk from potential movements in interest rates, foreign exchange rates, equity exposures and indexation exposures inherent to the Group's assets, liabilities and positions.

Loans to Customers

Loans to customers include overdrafts, credit card advances, mortgage loans, capital leases and other loans. They are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market with respect to which the Group has no intention of trading the loan or receivable. For capital leases, the Group remains the owner of the leased object. Loans to customers comprise loans to both individuals and corporates and represent the substantial majority of the Group's assets. Within loans to customers, other loans are mainly loans to corporates, including leases, revolving credit facilities, factoring and other traditional loans. The government guarantee schemes issued in response to COVID-19 are also included under loans to customers. These loans are subject to government guarantees from 70% to 100%.

For additional information on the Group's loan portfolio, see "*Selected Statistical Information—Loan Portfolio.*"

Investments in Associates

At year-end 2020, the Group classified Auðkenni hf. (an information security company), JCC ehf. (a cash centre service company) and Reiknistofa bankanna hf. (an IT service centre company) as investments in associates.

Associates are entities over which the Group has significant influence to participate in the financial and operating policy decisions of the entity but does not have control over those policies. It is presumed that the

Group has significant influence if the Group holds 20% to 50% of the voting power of an entity. Considerations made in determining significant influence are similar to those used to determine control over subsidiaries. The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. After the acquisition date, the carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets. Distributions received from an associate reduce the carrying amount of the investment.

The financial statements of the Group include the Group's share of profit or loss and other comprehensive income of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil, and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

Upon a loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

For information on the Group's interest in its principal associates as at 31 December 2020, see "*Legal Considerations and Supplementary Information—Significant Subsidiaries and Principal Associates.*"

Property and Equipment

Property and equipment include buildings, right-of-use assets, vehicles, fixtures and equipment. Items of property and equipment are measured at cost, less accumulated depreciation and impairment losses.

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. The depreciable amount of each item of property and equipment is determined after deducting its residual value. Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each item of property or equipment.

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

Deposits

Deposits include deposits from the Central Bank of Iceland, deposits from credit institutions and deposits from customers. Deposits from customers include deposits from individuals, companies, financial institutions, central government and state-owned enterprises, and municipalities.

For additional information on the Group's deposits, see "*—Funding—Deposit Funding.*"

Debt Issued and Other Borrowed Funds

Debt issued and other borrowed funds include covered bonds and senior unsecured bonds.

For additional information on the Group's debt issued and other borrowed funds, see "*—Funding—Debt Issued and Other Borrowed Funds.*"

Subordinated Loans

Subordinated loans include the Bank's Tier 2 capital, issued in 2017-2019 in Swedish króna (SEK) under the Bank's GMTN programme.

Key Changes to Financial Position as at 31 March 2021

Loans to credit institutions increased by ISK 13,413 million, to ISK 103,333 million as at 31 March 2021 from ISK 89,920 million as at 31 December 2020. This was primarily due to ISK 4,956 million increase in bank accounts and ISK 8,430 million increase in foreign currency money market loans.

Loans to customers increased by ISK 22,698 million, to ISK 1,029,415 million as at 31 March 2021 from ISK 1,006,717 million as at 31 December 2020. This increase was mostly driven by mortgage lending as demand for mortgages is consistently high, largely driven by the lower interest rate environment.

The Bank's ratio of non-performing loans fell from 2.9% as at 31 December 2020 to 2.4% as at 31 March 2021 as one material exposure was fully repaid.

The Bank's distribution of loans between individuals and companies was largely unchanged (46% to individuals as at 31 March 2021 compared to 43% as at 31 December 2020). The increase was primarily in mortgages to individuals.

Financial instruments decreased by ISK 17,853 million, to ISK 133,127 million as at 31 March 2021 from ISK 150,980 million as at 31 December 2020. This decrease was partially due to a decrease in foreign trading bonds offset by an increase in shares and equity instruments resulting from an increase in equity forwards, which were fully hedged by the Bank, and share price increases.

Other assets increased by ISK 13,441 million, to ISK 17,566 million as at 31 March 2021 from ISK 4,125 million as at 31 December 2020. This was primarily due to an increase in unsettled securities transactions at the end of the period.

Deposits increased by ISK 10,927 million, to ISK 730,140 million as at 31 March 2021 from ISK 719,213 million as at 31 December 2020. This was primarily due to strong growth in retail deposits.

Debt issued and other borrowed funds increased by ISK 10,951 million, to ISK 398,225 million as at 31 March 2021 from ISK 387,274 million as at 31 December 2020 as the Bank continued to build on its main long-term funding sources by issuing covered bonds and senior unsecured bonds.

Other liabilities increased by ISK 18,740 million, to ISK 30,660 million as at 31 March 2021 from ISK 11,920 million as at 31 December 2020. This was primarily due to an increase in unsettled securities transactions at the end of the period.

Changes in Assets as at 31 December 2020, 2019 and 2018

Loans to Credit Institutions

The table below sets forth the components of the loans to credit institutions as at the dates indicated.

	As at 31 December		
	2020	**2019**	**2018**
		(ISK in millions)	
Bank accounts	46,269	21,122	25,259
Money market loans	43,646	33,254	16,314
Other loans	5	-	4
Loans to credit institutions	**89,920**	**54,376**	**41,577**

Loans to credit institutions increased by ISK 35,544 million, or 65.4%, to ISK 89,920 million as at 31 December 2020 from ISK 54,376 million as at 31 December 2019. This was primarily due to ISK 25.1 billion increase in foreign currency bank accounts and ISK 10.4 billion increase in money market loans.

Loans to credit institutions increased by ISK 12,799 million, or 30.8%, to ISK 54,376 million as at 31 December 2019 from ISK 41,577 million as at 31 December 2018. This was primarily due to ISK 16.9 billion increase in money market loans. However, foreign currency bank accounts decreased by ISK 4.1 billion between years.

Loans to Customers

The table below sets forth the Group's loans to customers as at the dates indicated.

	As at 31 December		
	2020	**2019**	**2018**
		(ISK in millions)	
Overdrafts	42,212	48,938	48,581
Credit cards	16,888	19,026	18,242
Mortgage loans	377,155	281,499	249,296
Capital leases	43,359	45,623	45,116
Government guarantee schemes	3,594	-	-
Other loans	523,509	504,546	485,364
Loans to customers	**1,006,717**	**899,632**	**846,599**

Loans to customers increased by ISK 107,085 million, or 11.9%, to ISK 1,006,717 million as at 31 December 2020 from ISK 899,632 million as at 31 December 2019. This increase was a result of strong demand for residential mortgages which was largely driven by the lower interest rate environment. For corporate loans, the increase was mainly in loans in real estate and seafood sectors. Mortgage loans increased by ISK 95.7 billion. In 2020, new lending amounted to ISK 160 billion for individuals and ISK 149 billion for companies.

Loans to customers increased by ISK 53,033 million, or 6.3%, to ISK 899,632 million as at 31 December 2019 from ISK 846,599 million as at 31 December 2018. This increase was primarily due to demand for new credit from all of the Bank's business divisions. For corporate loans, the increase was mainly within construction sector. Mortgage loans increased by ISK 32.2 billion. In 2019, new lending amounted to ISK 226 billion, split across business divisions.

Financial Instruments

The table below sets forth the components of the financial instruments as at the dates indicated.

	As at 31 December		
	2020	**2019**	**2018**
		(ISK in millions)	
Bonds and debt instruments	128,216	52,870	69,415
Shares and equity instruments	14,851	18,426	13,074
Derivatives	6,647	5,621	4,550
Non-current assets and disposal groups held for sale	1,266	-	-
Financial instruments	**150,980**	**76,917**	**87,039**

Financial instruments increased by ISK 74,063 million, or 96.3%, to ISK 150,980 million as at 31 December 2020 from ISK 76,917 million as at 31 December 2019. This increase was primarily due to an increase in bonds and debt instruments as the Bank continued to shift liquidity to Treasury bills, short-dated Treasury bonds and covered bonds after the Central Bank of Iceland decided to stop offering one-month term deposits. The increase was also due to an increase in the hedge book for bond forwards.

Financial instruments decreased by ISK 10,122 million, or 11.6%, to ISK 76,917 million as at 31 December 2019 from ISK 87,039 million as at 31 December 2018. This decrease was partially due to decrease in bonds and debt instruments.

In general, the value of companies on the Icelandic stock market increased during the year 2020, with the OMX Iceland 10 Index increasing by 20.5%.

Property and equipment

Property and equipment decreased by ISK 1,827 million, or 19.9%, to ISK 7,341 million as at 31 December 2020 from ISK 9,168 million as at 31 December 2019. This decrease was primarily due to the sale of Borgun in 2020.

Property and equipment increased by ISK 3,897 million, or 73.9%, to ISK 9,168 million as at 31 December 2019 from ISK 5,271 million as at 31 December 2018. This increase was primarily due to the transition to IFRS 16 on 1 January 2019, which resulted in the Group recognising ISK 4,505 million of right-of-use assets.

Investments in Associates

The table below sets forth the components of the investments in associates as at the dates indicated.

	As at 31 December		
	2020	2019	2018
	(ISK in millions)		
Investments in associates at the beginning of the year	746	682	704
Additions during the year	–	–	86
Sales of shares in associates	–	–	(39)
Transfer from associates to subsidiaries	–	–	(80)
Transfer to "Non-current assets and disposal groups held for sale"	(15)	–	–
Dividends paid	–	–	(18)
Share of gain of associates	44	64	29
Investments in associates	**775**	**746**	**682**

Investments in associates increased by ISK 29 million, or 3.9%, to ISK 775 million as at 31 December 2020 from ISK 746 million as at 31 December 2019. This increase was due to a recognised share of gain of associates but was offset by the transfer of shares to non-current assets held for sale. The share of gain of associates is primarily due to profit in Reiknistofa bankanna hf. As at the date of this Prospectus, the Bank only holds shares in associates that are related to the Bank's operations.

Investments in associates increased by ISK 64 million, or 9.4%, to ISK 746 million as at 31 December 2019 from ISK 682 million as at 31 December 2018. This increase was due to a recognised share of gain of associates.

Changes in Liabilities as at 31 December 2020, 2019 and 2018

Deposits

Deposits increased by ISK 69,975 million, or 10.8%, to ISK 719,213 million as at 31 December 2020 from ISK 649,238 million as at 31 December 2019. This increase was primarily in retail and corporations (12%) and in financial institutions and pension funds (6%).

Deposits increased by ISK 54,660 million, or 9.2%, to ISK 649,238 million as at 31 December 2019 from ISK 594,578 million as at 31 December 2018. There was an increase across most customer groups, with significant increases in retail, domestic financial entities, and corporations.

Debt Issued and Other Borrowed Funds

Debt issued and other borrowed funds increased by ISK 80,893 million, or 26.4%, to ISK 387,274 million as at 31 December 2020 from ISK 306,381 million as at 31 December 2019. This increase was because the Bank continued to build on its main long-term funding sources by issuing covered bonds and senior unsecured bonds.

Debt issued and other borrowed funds increased by ISK 5,405 million, or 1.8%, to ISK 306,381 million as at 31 December 2019 from ISK 300,976 million as at 31 December 2018. This increase was due to the issuance of covered bonds, commercial papers and senior unsecured transactions in Icelandic Króna and senior unsecured transactions in foreign currencies as the Bank had good access to capital markets.

*Consolidated Income Statement**

	Three months ended 31 March		Year ended 31 December		
	2021	2020	2020	2019	2018
			(ISK in millions)		
Interest income	12,784	13,645	55,695	61,965	61,675
Interest expense	(4,594)	(5,065)	(22,324)	(29,143)	(29,738)
Net interest income	**8,190**	**8,580**	**33,371**	**32,822**	**31,937**
Fee and commission income	3,307	2,763	12,651	12,052	19,853
Fee and commission expense	(445)	(272)	(2,126)	(1,153)	(7,626)
Net fee and commission income	**2,862**	**2,491**	**10,525**	**10,899**	**12,227**
Net financial income (expense)	293	(1,738)	(1,391)	(820)	(962)
Net foreign exchange gain	130	55	451	139	1
Other operating income	123	19	197	2,125	1,784
Other net operating income	546	(1,664)	(743)	1,444	823
Total operating income	**11,598**	**9,407**	**43,153**	**45,165**	**44,987**
Salaries and related expenses	(3,574)	(3,247)	(12,917)	(14,019)	(15,500)
Other operating expenses	(2,278)	(2,445)	(9,829)	(10,469)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(183)	(228)	(679)	(936)	(1,173)
Bank tax	(410)	(359)	(1,588)	(3,528)	(3,281)
Total operating expenses	**(6,445)**	**(6,279)**	**(25,013)**	**(28,952)**	**(32,104)**
Profit before net impairment on financial assets	**5,153**	**3,128**	**18,140**	**16,213**	**12,883**
Net impairment on financial assets	(518)	(3,490)	(8,816)	(3,480)	1,584
Profit (loss) before tax	**4,635**	**(362)**	**9,324**	**12,733**	**14,467**
Income tax expense	(1,036)	(769)	(2,472)	(3,909)	(4,734)
Profit (loss) for the period from continuing operations	**3,599**	**(1,131)**	**6,852**	**8,824**	**9,733**
Discontinued operations, net of income tax	16	(245)	(97)	(370)	912
Profit (loss) for the period	**3,615**	**(1,376)**	**6,755**	**8,454**	**10,645**
Profit (loss) attributable to shareholders of the Bank	3,617	(1,251)	7,061	8,809	11,036
Loss attributable to non-controlling interests	(2)	(125)	(306)	(355)	(391)
Profit (loss) for the period	**3,615**	**(1,376)**	**6,755**	**8,454**	**10,645**
Earnings per share from continuing operations					
Basic and diluted earnings per share attributable to the shareholders of the Bank	0.36	(0.10)	0.72	0.92	1.01

***** For the three months ended 31 March 2020, and the years ended 31 December 2020 and 2019, the subsidiary Borgun was classified as discontinued operations.

Explanation of Selected Line Items from the Consolidated Income Statement

Interest Income and Interest Expense

For all financial assets and financial liabilities measured at amortised cost, interest income and interest expense are recognised in profit or loss using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset. For financial assets in Stage 1 and Stage 2, interest is recognised on the gross carrying amount of the assets and, for financial assets in Stage 3, interest is recognised on the gross carrying amount of the assets, net of impairment allowance.

Interest income and interest expense also include gains and losses on derecognition of financial assets and financial liabilities measured at amortised cost.

For financial assets and financial liabilities at fair value through profit and loss, interest income and interest expense are usually recognised on an accrual basis.

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro-denominated bonds issued by the Group, is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

Fee and Commission Income and Expense

The Group provides various services to its customers and earns income from such services, such as income from asset management, investment banking, brokerage, cards and payment processing, lending and guarantees, as well as other services.

Fees earned from services that are provided over a certain period of time are recognised as the services are provided. Performance-linked fees or fee components are recognised when the performance criteria are fulfilled. Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party are recognised on completion of the underlying transaction.

Where the Group is acting as an agent, the consideration is presented on a net basis.

Fee and commission income and expenses that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Net Financial Income (Expense)

Net financial income (expense) consists of net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss, net gain (loss) on financial liabilities designated as at fair value through profit or loss, and net gain (loss) on fair value hedges.

Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets and financial liabilities classified by the Group as mandatorily at fair value through profit or loss, except for interest income and interest expense, which are included in "Interest income" and "Interest expense," and foreign exchange gains and losses, which are included in "Net foreign exchange gain (loss)."

Dividend income from financial assets is recognised in the income statement when the Group's right to receive payment is established.

Net gain (loss) on financial liabilities designated as at fair value through profit or loss includes all realised and unrealised fair value changes of financial liabilities designated by the Group as at fair value through profit or loss, except for changes in fair value attributable to changes in credit risk, which is recognised in other comprehensive income, interests incurred, which are included in "Interest expense," and foreign exchange gains and losses, which are included in "Net foreign exchange gain (loss)."

Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are accounted for as hedging instruments in fair value hedges, and the changes in the fair value of certain bonds, which are attributable to the interest rate risk of the bonds and are accounted for as the hedged items in fair value hedges.

Net Foreign Exchange Gain

Net foreign exchange gain or loss includes all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in the financial statements for previous periods. Net foreign exchange gain or loss also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognised in profit or loss.

Other Operating Income

Other operating income includes the Group's profit share of associates, legal fees, rental income from property, and other income, such as settlement of legal dispute, profit or loss from sale of subsidiaries and associates, and profit or loss from sale of property and equipment.

Salaries and Related Expenses

Salaries and related expenses include salaries, cash bonuses, non-monetary benefits, compensated absences, contributions to pension funds, social security charges, financial activities tax (5.5%) and other salary-related expenses.

For information on compensation paid to members of the Board of Directors and the Executive Committee, see "*Board of Directors, Executive Committee, Auditor and Corporate Governance— Service Agreements, Remuneration and Entitlements of Members of the Board of Directors and Executive Committee*".

Other Operating Expenses

Other operating expenses consist of professional services, information system-related expenses, housing expenses, depreciation of property and equipment, amortisation of intangible assets, and other operating expenses, such as advertising expenses, office expenses, and various public expenses.

For additional information, see "*Operating and Financial Review—Key Factors Affecting the Group's Business, Financial Position and Results of Operations—Cost and Efficiency Management*".

Bank Tax

Bank tax is calculated as 0.145% of total liabilities at year-end 2020 as determined for tax purposes, in excess of ISK 50,000 million, excluding tax liabilities. The Bank tax is considered a non-deductible expense for the calculation of income tax. For the years ended 31 December 2019 and 2018 the bank tax was 0.376%. Non-financial subsidiaries are exempt from the Bank tax.

Net Impairment on Financial Assets

The impairment model of IFRS 9 is forward-looking and impairment under IFRS 9 should reflect a probability weighted average of possible outcomes. In addition, the expected credit loss model in IFRS 9 employs a dual measurement approach, under which the loss allowance for expected credit losses (ECL) is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk (SICR) of the financial instrument since initial recognition. To satisfy the provisions of IFRS 9, a significant amount of modelling is required. The models which the Group uses for the calculation of the impairment amount are developed according to the Group's modelling framework. This framework imposes structure on the initial model development work, the model documentation including educational material as needed for users, the approval process for models, the implementation of models and the lifetime support for models, including validation and back-testing. The Group's impairment process, which encompasses all the steps needed to derive the appropriate impairment allowance for each accounting period, is documented and approved by the Bank's all-risk committee (the "ARC").

<u>Stage Assignment</u>

At each reporting date, all assets subject to the impairment methodology must be divided into three groups, termed "Stages", reflecting the extent of credit deterioration since initial recognition. This division then has influences on how the impairment is measured and how interest is recognised.

Stage 1

All assets that have not experienced a SICR are assigned to Stage 1. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from credit events occurring within 12 months of the reporting date (12- month ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 2

Assets that the Group determines to have experienced a SICR, but are not credit-impaired, are classified as Stage 2. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from all credit events occurring within the expected lifetime of the assets (lifetime ECL). Interest is recognised on the gross carrying amount of the assets.

The Group's definition of a SICR is on the level of an individual asset. The Group assesses that there has been a significant increase in credit risk of an asset if the probability of a credit impairment event, i.e. transfer to

Stage 3, occurring over the lifetime of the asset has increased significantly from the origination of the assets. For this purpose, origination does not refer to any modification events which have not resulted in derecognition of the asset. The assessment is based on a defined set of triggers. This includes, as a backstop, the trigger that the asset is more than thirty days past due. Other triggers include internal assessments of outlook, events such as forbearance events which are less severe than a credit event, external credit related information and a significant deterioration in risk assessment compared to the risk assessment done in relation to the origination of the asset. The definition of SICR depends on the probability of a credit event occurring and does not consider collateralisation or any other information related to the expected loss arising from the event. As soon as all triggers for Stage 2 for a particular asset are no longer applicable then the asset moves back to Stage 1. Additionally, assets are classed as forborne for two years after a forbearance event has occurred, but forbearance events only cause assets to be in Stage 2 for twelve months and then they migrate back to Stage 1 unless other triggers apply.

The Group does not employ the low credit risk exemption in the Stage assignment process. In alignment with its operating procedures, the Group has chosen as its accounting policy to measure the impairment allowance for lease receivables at an amount equal to the lifetime ECL only for those assets, which have a SICR or are credit impaired. For other lease receivables the impairment allowance is equal to the 12-month ECL.

Stage 3

Stage 3 is for assets that are credit impaired according to the Group's assessment. These assets are therefore experiencing an ongoing credit event. Thus, the 12-month ECL and lifetime ECL are the same amount and this amount is recognised as impairment allowance. For assets in this Stage, interest is recognised on the net carrying amount of assets, i.e. net of impairment allowance.

The Group's definition of credit-impaired is on a customer level, rather than on the level of an individual asset. According to the definition, a customer is credit-impaired when either of the following holds:

a) the Group assesses that it is unlikely that the customer can service all of their commitments to the Group in accordance with the terms of the agreements without recourse to the default provisions in the agreements; or

b) the customer is more than 90 days past due on any of their commitments.

The assessment in a) is based on a defined set of triggers, which includes material breaches of covenants, material registrations on an internal watch list, initiation of material collection actions and material external credit related information.

Furthermore, there is a defined set of conditions which must be satisfied so that customers that have been assessed as being credit-impaired are no longer subject to this assessment. This includes probation periods and a view to the future outlook of the customer.

Expected Credit Loss (ECL)

The ECL for each asset is calculated using models for the probability of a credit impairment event occurring (PD), the loss percentage expected in case of such an event (LGD) and the outstanding amount at the time of the event (EAD). In its simplest form the ECL can be calculated as the product of these factors, however, for several reasons, the actual formula is more complicated.

The Group uses the standardised approach for regulatory capital purposes but has used PD models and LGD models for risk management purposes for several years. These models have been adapted for IFRS 9 purposes. For EAD, and for LGD to a certain extent, new models have been developed.

The PD models are either fully automated statistical models, expert models or hybrid. For the models with a component involving expert input there is a process in place to ensure proper review of the model outcome and periodic reassessment of obligors. The inputs into the models include demographic variables, information from financial statements and past payment behaviour, among other variables.

The effects of the economy on the PD is accounted for with the use of scaling factors which map through-the-cycle PD values to point-in-time PD values. The Group has a model to predict these scaling factors based on an economic forecast. The economic forecast is provided by the Group's Chief Economist. The forecast predicts a range of macroeconomic indicators over a horizon of five years. The model is applied to a subset of these indicators and produces a set of scaling factors. The scaling factors are then reviewed by the ARC with respect to all of the indicators and any other relevant information available and the committee approves their use for the calculation of the impairment. This process is carried out at least quarterly.

The Group uses three economic scenarios to calculate the ECL. In addition to the base forecast, scaling factors are produced for a good and bad case. This is done in order to represent the whole range of possible future economic developments. The actual impairment allowance is the weighted average of the ECL in these different scenarios.

The ARC determined that it was appropriate to adjust the weights of the scenarios due to COVID-19. Previously the scenarios were weighted 25% -50% -25% (good, base, bad) but it was deemed appropriate to set the weights at 15%-55%-30% at year-end 2020, as this would best represent the probability-weighted average over all possible scenarios. These weights were changed again for the end of Q1-2021, to 10%, 55%, 35% (good, base, bad).

The LGD model considers several scenarios for how a facility may develop once a credit event has occurred. One possibility is that the facility cures without a loss. If not, the recoveries may be based on the seizing of collateral and to estimate such recoveries, several scenarios for the development of the value of the collateral are considered. Finally, there may be recoveries even though a formal collateral is not in place. These different recovery scenarios are weighted differently depending on the economic scenario under consideration. This leads to a non-linear interaction and thus a difference between the probability weighted average ECL and the ECL in the most likely scenario.

For EAD it is necessary to account for expected prepayments on term loans and for the expected utilisation of commitments such as credit cards, overdrafts, financial guarantees, and credit lines. The expected lifetime of agreements may also extend beyond the contractual lifetime for contracts which are generally extended.

Temporary changes have been made to the impairment models due to COVID-19. For additional information, see note 3 "Significant accounting estimates and judgements" in the 2020 Annual Financial Statements.

Write-off Policy

When the Group has no reasonable expectations of recovering a credit exposure or when it is uneconomical to pursue legal collection, the financial asset is written off. A write-off does not change the debt obligation which is therefore still subject to enforcement activity. Any recoveries of amounts previously written off are credited to the income statement.

Income Tax Expense

Income tax expense comprises special financial activities tax, current tax and deferred tax. Income tax expense from discontinued operations is included in "Discontinued operations, net of income tax". Income tax is recognised in profit or loss, except to the extent that it relates to items recognised directly in equity, consistent with the recognition of the underlying item to which it relates.

Current tax is the expected tax payable on the taxable income for the year using tax rates enacted at the reporting date. Current tax also includes any adjustment to tax payable in respect of previous years.

The income tax rate for legal entities in Iceland has been 20.0% for each of the years ended 31 December 2020, 2019 and 2018 and, in addition, there has been a special financial activities tax calculated as 6% of taxable profit exceeding ISK 1.0 billion.

Deferred tax is recognised based on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts. However, deferred taxes are not recognised if they arise from the initial recognition of an asset or liability, in a transaction other than a business combination, that at the time of the transaction affects neither the taxable profit nor the accounting profit. In addition, deferred taxes are not recognised if the temporary difference arises from the initial recognition of goodwill. Deferred tax is measured using tax rates enacted at the reporting date.

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

Discontinued Operations, net of Income Tax

Discontinued operations consist of profit or loss from foreclosed assets and disposal groups held for sale, gain or loss recognised on the measurement to fair value less costs to sell in excess of book value of foreclosed assets, profit or loss from sale of foreclosed assets and disposal groups held for sale, and income tax expense from discontinued operations.

Key Changes to Results of Operations for the Three Months Ended 31 March 2021 and 2020

Interest income decreased by ISK 861 million, or 6.3%, to ISK 12,784 million for the three months ended 31 March 2021 from ISK 13,645 million for the three months ended 31 March 2020. This decrease was primarily due to the lower interest rate environment. Interest expense decreased by ISK 471 million, or 9.3%, to ISK 4,594 million for the three months ended 31 March 2021 from ISK 5,065 million for the three months ended 31 March 2020. This decrease was primarily due to the lower interest rate environment.

Fee and commission income increased by ISK 544 million, or 19.7%, to ISK 3,307 million for the three months ended 31 March 2021 from ISK 2,763 million for the three months ended 31 March 2020. Fee and commission expense increased by ISK 173 million, or 63.6%, to ISK 445 million for the three months ended 31 March 2021 from ISK 272 million for the three months ended 31 March 2020. Net fee and commission income increased by 14.9% between years, well distributed across business segments.

Net financial income increased by ISK 2,031 million, or 116.9%, to ISK 293 million for the three months ended 31 March 2021 from net financial expense of ISK 1,738 million for the three months ended 31 March 2020. Net valuation changes and favourable market conditions were the main reasons for the increase in net financial income.

Other operating income increased by ISK 104 million, or 547.4%, to ISK 123 million for the three months ended 31 March 2021 from ISK 19 million for the three months ended 31 March 2020. This increase was primarily due to reversal of impairment for an associate.

Salaries and related expenses increased by ISK 327 million, or 10.1%, to ISK 3,574 million for the three months ended 31 March 2021 from ISK 3,247 million for the three months ended 31 March 2020. This increase was primarily due to wage increases in line with the general wage agreements in Iceland, redundancy costs and accrued leave.

Other operating expenses decreased by ISK 167 million, or 6.8%, to ISK 2,278 million for the three months ended 31 March 2021 from ISK 2,445 million for the three months ended 31 March 2020. This decrease was primarily due to membership fees in other administrative expenses.

Net impairment on financial assets decreased by ISK 2,972 million, or 85.2%, to ISK 518 million for the three months ended 31 March 2021 from ISK 3,490 million for the three months ended 31 March 2020. The decrease was primarily due to an increase related to the COVID-19 pandemic (ISK 960 million), a decrease due to a more favourable economic environment (ISK 363 million) and a decreased expected credit loss for a few customers (ISK 215 million).

Income tax expense increased by ISK 267 million, or 34.7%, to ISK 1,036 million for the three months ended 31 March 2021 from ISK 769 million for the three months ended 31 March 2020. Income tax comprises 20.0% income tax on taxable profit and the Special Financial Activity Tax is calculated as 6% of taxable profit exceeding ISK 1 billion. The effective income tax rate was 22.4% for the three months ended 31 March 2021, as compared to negative 212.4% for the three months ended 31 March 2020.

Discontinued operations, net of income tax increased by ISK 261 million, or 106.5%, to ISK 16 million for the three months ended 31 March 2021 from ISK 245 million loss for the three months ended 31 March 2020. This increase was primarily due to loss in the subsidiary Borgun, which was classified as disposal group held for sale for the first quarter of 2020.

Results of Operations for the years ended 31 December 2020, 2019 and 2018

Interest Income

The table below sets forth the components of the interest income for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Cash and balances with Central Bank	1,750	4,452	7,279
Loans at amortised cost	51,628	54,837	52,462
Financial assets mandatorily at fair value through profit or loss	2,314	2,630	1,825
Other assets	3	46	109
Interest income	**55,695**	**61,965**	**61,675**

Interest income decreased by ISK 6,270 million, or 10.1%, to ISK 55,695 million for the year ended 31 December 2020 from ISK 61,965 million for the year ended 31 December 2019. This decrease was partly due to a lower interest rate environment.

Interest income increased by ISK 290 million, or 0.5%, to ISK 61,965 million for the year ended 31 December 2019 from ISK 61,675 million for the year ended 31 December 2018. This increase was primarily due to a growth in the loan book.

Interest Expense

The table below sets forth the components of the interest expense for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Deposits from Central Bank and credit institutions	(736)	(625)	(409)
Deposits from customers	(7,700)	(15,242)	(16,539)
Debt issued and other borrowed funds at fair value through profit or loss	(608)	(734)	(963)
Debt issued and other borrowed funds at amortised cost	(11,179)	(9,818)	(9,035)
Subordinated loans	(763)	(501)	(198)
Other interest expense	(1,338)	(2,223)	(2,594)
Interest expense	**(22,324)**	**(29,143)**	**(29,738)**

Interest expense decreased by ISK 6,819 million, or 23.4%, to ISK 22,324 million for the year ended 31 December 2020 from ISK 29,143 million for the year ended 31 December 2019. This decrease was primarily due to a lower interest rate environment.

Interest expense decreased by ISK 595 million, or 2.0%, to ISK 29,143 million for the year ended 31 December 2019 from ISK 29,738 million for the year ended 31 December 2018. This decrease was primarily due to lower interest expenses from deposits from customers due to lower interest rates.

Fee and Commission Income

The table below sets forth the components of the fee and commission income for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Asset management	2,382	2,225	2,116
Investment banking and brokerage	2,487	2,430	2,303
Payment processing	4,378	3,810	12,065
Loans and guarantees	2,014	1,510	1,467
Other fee and commission income	1,390	2,077	1,902
Fee and commission income	**12,651**	**12,052**	**19,853**

Fee and commission income increased by ISK 599 million, or 5.0%, to ISK 12,651 million for the year ended 31 December 2020 from ISK 12,052 million for the year ended 31 December 2019. This increase was primarily in fees from loans and guarantees as a result of an increase in new lending and refinancing.

Fee and commission income decreased by ISK 7,801 million, or 39.3%, to ISK 12,052 million for the year ended 31 December 2019 from ISK 19,853 million for the year ended 31 December 2018, as a result of the presentation of 2019 figures excluding the impact of Borgun. Excluding the impact of Borgun on 2018 and 2019, fee and commission income increased by ISK 669 million, or 5.9%, to ISK 12,052 million for the year ended 31 December 2019 from ISK 11,383 million for the year ended 31 December 2018. This increase was primarily due to an increase in payment processing fees.

Fee and Commission Expense

The table below sets forth the components of the fee and commission expense for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Brokerage	(360)	(337)	(300)
Clearing and settlement	(1,766)	(806)	(7,302)
Other fee and commission expense	–	(10)	(24)
Fee and commission expense	**(2,126)**	**(1,153)**	**(7,626)**

Fee and commission expense increased by ISK 973 million, or 84.4%, to ISK 2,126 million for the year ended 31 December 2020 from ISK 1,153 million for the year ended 31 December 2019. This increase was primarily in clearing and settlement fees as intercompany eliminations were ceased following the sale of Borgun.

Fee and commission expense decreased by ISK 6,473 million, or 84.9 %, to ISK 1,153 million for the year ended 31 December 2019 from ISK 7,626 million for the year ended 31 December 2018, as a result of the presentation of 2019 figures excluding the impact of Borgun. Excluding the impact of Borgun on 2018 and 2019, fee and commission expense increased by ISK 193 million, or 20.1%, to ISK 1,153 million for the year ended 31 December 2019 from ISK 960 million for the year ended 31 December 2018. This increase was primarily due to increased card expenses.

Net Financial Expense

The table below sets forth the components of the net financial expense for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Net loss on financial assets and financial liabilities mandatorily at fair value through profit or loss	(1,321)	(422)	(720)
Net loss on financial liabilities designated as at fair value through profit or loss	(72)	(399)	(240)
Net gain (loss) on fair value hedges	2	1	(2)
Net financial expense	**(1,391)**	**(820)**	**(962)**

Net financial expense increased by ISK 571 million, or 69.6%, to ISK 1,391 million for the year ended 31 December 2020 from ISK 820 million for the year ended 31 December 2019. This increase was primarily due to losses in the trading book and the banking book, CPI hedges and fair value changes in shares.

Net financial expense decreased by ISK 142 million, or 14.8%, to ISK 820 million for the year ended 31 December 2019 from ISK 962 million for the year ended 31 December 2018. This decrease was primarily due to losses in the trading book.

Net Foreign Exchange Gain

The table below sets forth the components of the net foreign exchange gain for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Cash and balances with Central Bank	160	(222)	(193)
Financial assets mandatorily at fair value through profit or loss	13,652	(1,781)	2,281
Loans at amortised cost	22,673	5,686	17,120
Other assets	10	-	305
Net foreign exchange gain for assets	36,495	3,683	19,513
Deposits	(10,279)	(1,749)	(7,938)
Debt issued and other borrowed funds designated as at fair value through profit or loss	(6,468)	(1,667)	(3,868)
Debt issued and other borrowed funds at amortised cost	(14,802)	(362)	(6,567)
Subordinated loans	(4,495)	234	(884)
Other liabilities	-	-	(255)
Net foreign exchange loss for liabilities	(36,044)	(3,544)	(19,512)
Net foreign exchange gain	**451**	**139**	**1**

Net foreign exchange gain increased by ISK 312 million, or 224.5%, to ISK 451 million for the year ended 31 December 2020 from ISK 139 million for the year ended 31 December 2019. This increase was primarily due to reduced losses in the banking book.

Net foreign exchange gain increased by ISK 138, or 139%, million to ISK 139 million for the year ended 31 December 2019 from ISK 1 million for the year ended 31 December 2018. This increase was primarily due to reduced losses in the banking book.

Other Operating Income

The table below sets forth the components of the other operating income for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Share of profit of associates, net of income tax	44	63	29
Legal dispute settlement	–	1,103	–
Legal fees	90	93	83
Rental income	39	38	37
Depositor's and Investor's Guarantee Fund reversed contribution	–	847	–
Net gain (loss) from sale of subsidiaries	–	(16)	1,526
Other net operating income (expense)	24	(3)	109
Other operating income	**197**	**2,125**	**1,784**

Other operating income decreased by ISK 1,928 million, or 90,7%, to ISK 197 million for the year ended 31 December 2020 from ISK 2,125 million for the year ended 31 December 2019. This decrease was primarily due to one-off items in 2019.

Other operating income increased by ISK 341 million, or 19.1%, to ISK 2,125 million for the year ended 31 December 2019 from ISK 1,784 million for the year ended 31 December 2018. This increase was primarily due to one-off items related to a settlement of the Bank's claim deriving from the acquisition of Byr savings bank in 2011 amounting to ISK 1,103 million and a reversal of previously expensed contribution to the Depositors' and Investors' Guarantee Fund relating to past changes in the legislation on deposit insurance amounting to ISK 847 million.

Salaries and Related Expenses

The table below sets forth the components of the salaries and related expenses for the periods indicated.

	Year ended 31 December		
	2020	2019	2018
	(ISK in millions)		
Salaries	9,940	10,801	11,923
Contributions to pension funds	1,505	1,618	1,767
Social security charges and financial activities tax	1,391	1,493	1,723
Other salary-related expenses	81	107	95
Capitalisation of internal staff costs in software development	–	–	(8)
Salaries and related expenses	**12,917**	**14,019**	**15,500**

Salaries and related expenses decreased by ISK 1,102 million, or 7.9%, to ISK 12,917 million for the year ended 31 December 2020 from ISK 14,019 million for the year ended 31 December 2019. This decrease was mainly due to employee reductions resulting in lower salaries and related expenses. Full-time equivalent positions at year-end 2020 totalled 779 for the Group, 4 employees less than at year-end 2019 excluding the impact of Borgun.

Salaries and related expenses decreased by ISK 1,481 million, or 9.6%, to ISK 14,019 million for the year ended 31 December 2019 from ISK 15,500 million for the year ended 31 December 2018, as a result of the presentation of 2019 figures excluding the impact of Borgun. Excluding the impact of Borgun on 2018 and 2019, salaries and related expenses increased by ISK 591 million, or 4.4%, to ISK 14,019 million for the year ended 31 December 2019 from ISK 13,428 million for the year ended 31 December 2018. This increase was mainly due to general wage increases and substantial redundancy payments, offset by a reduction in the number of employees in the Bank. Excluding Borgun full-time equivalent positions at year-end 2019 for the Group totalled 783, which was 85 employees less than at year-end 2018.

Other Operating Expenses

The table below sets forth the components of the other operating expenses for the periods indicated.

	Year ended 31 December		
	2020	2019	2018
	(ISK in millions)		
Professional services	1,539	1,778	2,385
Software and IT expenses	4,581	4,616	4,568
Real estate and office equipment	627	593	1,796
Depreciation, amortisation and write-offs	1,666	1,725	1,312
Other administrative expenses	1,416	1,757	2,089
Other operating expenses	**9,829**	**10,469**	**12,150**

Other operating expenses decreased by ISK 640 million, or 6.1%, to ISK 9,829 million for the year ended 31 December 2020 from ISK 10,469 million for the year ended 31 December 2019. This decrease was primarily due to an overall reduction in the Bank's cost base, partly due to COVID-19.

Other operating expenses decreased by ISK 1,681 million, or 13.8%, to ISK 10,469 million for the year ended 31 December 2019 from ISK 12,150 million for the year ended 31 December 2018. This decrease was primarily due to the impact of the exclusion of Borgun in 2019, a lower cost in office equipment and professional services, offset by an increase in depreciations due to investment in the core banking system.

Net Impairment on Financial Assets

The table below sets forth the components of the net impairment on financial assets for the periods indicated.

	Year ended 31 December		
	2020	2019	2018
	(ISK in millions)		
Expected credit losses, on-balance sheet items	(8,450)	(3,341)	529
Expected credit losses, off-balance sheet items	(366)	(52)	38
Changes in provision due to court rulings	-	(87)	1,017
Net impairment on financial assets	**(8,816)**	**(3,480)**	**1,584**

Net impairment on financial assets increased by ISK 5,336 million, or 153.3%, to a negative net impairment of ISK 8,816 million for the year ended 31 December 2020 from a negative net impairment of ISK 3,480 million for the year ended 31 December 2019. The increase in negative net impairment was due to an increase related to COVID-19 (ISK 6,115 million), increased expected credit loss for a few customers (ISK 1,185 million), and due to a less favourable economic environment (ISK 583 million).

Net impairment on financial assets decreased by ISK 5,064 million, or 319.7%, to a negative net impairment of ISK 3,480 million for the year ended 31 December 2019 from a positive net impairment of ISK 1,584 million for the year ended 31 December 2018. The decrease in net impairment was due to an increased expected credit loss for a few customers (ISK 1,178 million), due to a less favourable economic environment (ISK 992 million), and an unfavourable ruling in a court case (ISK 787 million).

Income Tax Expense

The table below sets forth the components of the income tax expense for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Current tax expense excluding discontinued operations	3,052	2,610	3,205
Special financial activities tax	801	642	860
Difference in prior year's calculated income tax	68	(1)	196
Changes in deferred tax assets and deferred tax liabilities	(1,449)	658	473
Income tax expense	**2,472**	**3,909**	**4,734**

Income tax expense decreased by ISK 1,437 million, or 36.8%, to ISK 2,472 million for the year ended 31 December 2020 from ISK 3,909 million for the year ended 31 December 2019. Fluctuation in the effective tax rate is mainly due to a combination of dissimilar tax rates for different types of income. The tax base decrease is mainly due to the lower Bank Levy and income that are not subject to tax such as gain on equity exposures. Income tax comprises 20.0% income tax on taxable profit and the Special Financial Activity Tax is calculated as 6% of taxable profit exceeding ISK 1 billion. The effective income tax rate was 26.5% in 2020, as compared to 30.7% in 2019.

Income tax expense decreased by ISK 825 million, or 17.4%, to ISK 3,909 million for the year ended 31 December 2019 from ISK 4,734 million for the year ended 31 December 2018. Fluctuation in the effective tax rate is mainly due to a combination of dissimilar tax rates for different types of income. The tax base decrease is mainly due to income or expense that are not subject to tax such as gain on equity exposures. Income tax comprises 20.0% income tax on taxable profit and the Special Financial Activity Tax is calculated as 6% of taxable profit exceeding ISK 1 billion. The effective income tax rate was 30.7% in 2019, as compared to 32.7% in 2018.

To calculate the effective income tax rate for the Group (26.5%, 30.7% and 32.7% for the years ended 31 December 2020, 2019 and 2018, respectively), it is necessary to factor into earnings before tax any non-deductible expenses and taxes, tax-exempt revenue and other applicable changes, the calculation of which is set forth in the note titled "*Income tax expense*" in the Annual Financial Statements of the relevant year. The lower effective income tax rate for the Group in 2020 was primarily driven by tax-exempt income relating to the equity positions held by the Group and the lower Bank Levy.

Discontinued Operations, net of Income Tax

The table below sets forth the components of the discontinued operations, net of income tax for the periods indicated.

	Year ended 31 December		
	2020	**2019**	**2018**
	(ISK in millions)		
Net profit (loss) from foreclosed assets	37	(178)	73
Net profit (loss) from disposal groups held for sale	(542)	(171)	854
Net profit from sale of a subsidiary	427	-	-
Income tax expense	(19)	(21)	(15)
Discontinued operations, net of income tax	**(97)**	**(370)**	**912**

Discontinued operations, net of income tax increased by ISK 273 million, or 73.8%, to negative ISK 97 million for the year ended 31 December 2020 from negative ISK 370 million for the year ended 31 December 2019. This increase was primarily due to the profit from the sale of Borgun, which was offset by the increased loss for the year 2020 in subsidiaries.

Discontinued operations, net of income tax decreased by ISK 1,282 million, or 140.6%, to negative ISK 370 million for the year ended 31 December 2019 from positive ISK 912 million for the year ended 31 December 2018. This decrease was primarily due to an impairment on foreclosed assets and loss for the year 2019 in subsidiaries, compared to profit for the year in 2018.

Segmental Analysis

Segment information is presented in accordance with the Group's management and internal reporting structure. The Bank has three main business divisions: Personal Banking, Business Banking and Corporate & Investment Banking. Operating divisions pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium. Capital allocation to the business divisions is based on the Pillar 1 regulatory capital requirement, the Pillar 2-R capital requirement calculated according to the Bank's ICAAP and the combined buffer requirement as stipulated in the act on financial undertakings. Income tax and bank tax with breakdown for each division is according to the current tax rates.

Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. The Bank's customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services and contact the contact centre.

Business Banking provides SMEs with comprehensive financial services and Ergo, the Bank's asset-based financing unit, is also part of the division. Business Banking serves customers in business centres and branches close to their business. Via online banking and the Bank's app, customers have full overview of their business and day-to-day operations are easy to manage.

Corporate & Investment Banking provides comprehensive universal financial and investment banking services to large companies, municipalities, institutional investors, and high-net worth individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage, and private banking services. The division is focused on building and maintaining relationships across all industry divisions within Iceland. Outside of Iceland, the Bank has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business divisions sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres comprise the CEO's office (Human Resources, Marketing & Communications, Strategy, and Legal), Finance excluding Treasury and Proprietary Trading, IT, Risk Management and Compliance. Group Internal Audit is included in cost centres; however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank's Board of Directors.

Subsidiaries include Iceland Funds, Allianz Ísland hf. and other less significant subsidiaries.

The tables below set forth certain information with respect to the Group's operating divisions for the periods indicated.

2020	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	10,749	10,536	8,530	3,734	(215)	33,334	37	33,371
Net fee and commission income	3,049	1,917	4,075	(317)	7	8,731	1,794	10,525
Other net operating income	305	50	922	(1,420)	287	144	(887)	(743)
Total operating income	14,103	12,503	13,527	1,997	79	42,209	944	43,153
Salaries and related expenses	(2,416)	(1,940)	(1,583)	(280)	(5,926)	(12,145)	(772)	(12,917)
Other operating expenses	(2,584)	(1,164)	(870)	(263)	(4,488)	(9,369)	(460)	(9,829)
Contribution to the Depositors' and Investors' Guarantee Fund	(482)	(161)	(35)	(1)	-	(679)	-	(679)
Bank tax	(613)	(340)	(514)	(105)	(16)	(1,588)	-	(1,588)
Net impairment on financial assets	(517)	(5,485)	(2,805)	(8)	-	(8,815)	(1)	(8,816)
Cost allocation	(4,690)	(2,967)	(3,020)	323	10,354	-	-	-
Profit (loss) before tax	2,801	446	4,700	1,663	3	9,613	(289)	9,324
Income tax expense	(887)	(204)	(1,356)	112	(5)	(2,340)	(132)	(2,472)
Profit (loss) for the year from continuing operations	1,914	242	3,344	1,775	(2)	7,273	(421)	6,852
Net segment revenue from external customers	20,911	14,750	19,922	(13,597)	223	42,209	944	43,153
Net segment revenue from other segments	(6,808)	(2,247)	(6,395)	15,594	(144)	-	-	-
Fee and commission income	4,797	1,948	4,152	(9)	7	10,895	1,756	12,651
Depreciation, amortisation and write-offs	(300)	(163)	(18)	-	(1,178)	(1,659)	(7)	(1,666)
At 31 December 2020								
Loans to customers	419,882	232,580	353,953	302	-	1,006,717	-	1,006,717
Other assets	3,212	2,199	795	320,578	10,893	337,677	(203)	337,474
Total segment assets	**423,094**	**234,779**	**354,748**	**320,880**	**10,893**	**1,344,394**	**(203)**	**1,344,191**
Deposits from customers	324,815	189,847	137,791	31,674	-	684,127	(4,672)	679,455
Other liabilities	1,327	1,481	4,908	463,943	5,915	477,574	958	478,532
Total segment liabilities	**326,142**	**191,328**	**142,699**	**495,617**	**5,915**	**1,161,701**	**(3,714)**	**1,157,987**
Allocated equity	34,850	37,804	63,432	45,708	899	182,693	3,511	186,204
Risk exposure amount	229,610	235,371	392,804	60,037	5,960	923,782	9,739	933,521

2019	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	10,578	10,812	8,397	3,169	(251)	32,705	117	32,822
Net fee and commission income	4,504	1,716	3,530	(236)	7	9,521	1,378	10,899
Other net operating income	77	25	564	(848)	2,197	2,015	(571)	1,444
Total operating income	15,159	12,553	12,491	2,085	1,953	44,241	924	45,165
Salaries and related expenses	(2,791)	(1,993)	(1,720)	(253)	(6,516)	(13,273)	(746)	(14,019)
Other operating expenses	(2,131)	(1,184)	(660)	(257)	(5,725)	(9,957)	(512)	(10,469)
Contribution to the Depositors' and Investors' Guarantee Fund	(530)	(314)	(89)	(3)	-	(936)	-	(936)
Bank tax	(483)	(339)	(486)	(2,205)	(15)	(3,528)	-	(3,528)
Net impairment on financial assets	(547)	(1,098)	(1,043)	(791)	-	(3,479)	(1)	(3,480)
Cost allocation	(5,606)	(3,381)	(3,421)	278	12,130	-	-	-
Profit (loss) before tax	3,071	4,244	5,072	(1,146)	1,827	13,068	(335)	12,733
Income tax expense	(924)	(1,192)	(1,445)	318	(478)	(3,721)	(188)	(3,909)
Profit (loss) for the year from continuing operations	2,147	3,052	3,627	(828)	1,349	9,347	(523)	8,824
Net segment revenue from external customers	18,137	14,492	19,191	(9,708)	2,129	44,241	924	45,165
Net segment revenue from other segments	(2,978)	(1,939)	(6,700)	11,793	(176)	-	-	-
Fee and commission income	6,224	1,724	3,574	124	8	11,654	398	12,052
Depreciation, amortisation and write-offs	(215)	(112)	(21)	-	(1,367)	(1,715)	(10)	(1,725)
At 31 December 2019								
Loans to customers	329,265	230,842	334,788	2	-	894,897	4,735	899,632
Other assets	3,553	3,085	347	267,384	10,648	285,017	14,841	299,858
Total segment assets	**332,818**	**233,927**	**335,135**	**267,386**	**10,648**	**1,179,914**	**19,576**	**1,199,490**
Deposits from customers	290,894	167,623	113,455	49,517	-	621,489	(3,176)	618,313
Other liabilities	1,497	1,822	2,553	374,459	6,209	386,540	14,575	401,115
Total segment liabilities	**292,391**	**169,445**	**116,008**	**423,976**	**6,209**	**1,008,029**	**11,399**	**1,019,428**
Allocated equity	29,981	38,924	58,953	42,882	1,145	171,885	8,177	180,062
Risk exposure amount	194,601	247,565	367,456	48,063	6,968	864,653	19,897	884,550

2018	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	9,946	9,788	7,676	3,649	(218)	30,841	1,096	31,937
Net fee and commission income	4,564	1,477	3,321	(109)	12	9,265	2,962	12,227
Other net operating income	1	41	353	1,070	282	1,747	(924)	823
Total operating income	14,511	11,306	11,350	4,610	76	41,853	3,134	44,987
Salaries and related expenses	(2,585)	(2,069)	(1,641)	(258)	(6,185)	(12,738)	(2,762)	(15,500)
Other operating expenses	(2,466)	(1,062)	(680)	(494)	(5,646)	(10,348)	(1,802)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(669)	(395)	(109)	-	-	(1,173)	-	(1,173)
Bank tax	(434)	(327)	(470)	(2,041)	(9)	(3,281)	-	(3,281)
Net impairment on financial assets	579	955	164	(37)	-	1,661	(77)	1,584
Cost allocation	(5,134)	(2,813)	(2,660)	423	10,184	-	-	-
Profit (loss) before tax	3,802	5,595	5,954	2,203	(1,580)	15,974	(1,507)	14,467
Income tax expense	(989)	(1,455)	(1,548)	(1,280)	411	(4,861)	127	(4,734)
Profit (loss) for the year from continuing operations	2,813	4,140	4,406	923	(1,169)	11,113	(1,380)	9,733
Net segment revenue from external customers	14,958	14,996	17,337	(5,733)	295	41,853	3,134	44,987
Net segment revenue from other segments	(447)	(3,690)	(5,987)	10,343	(219)	-	-	-
Fee and commission income	5,990	1,612	3,420	133	12	11,167	8,686	19,853
Depreciation, amortisation and write-offs	(275)	(142)	(26)	(38)	(688)	(1,169)	(143)	(1,312)
At 31 December 2018								
Loans to customers	299,429	219,608	322,974	904	-	842,915	3,684	846,599
Other assets	1,332	3,151	316	252,085	8,056	264,940	18,864	283,804
Total segment assets	**300,761**	**222,759**	**323,290**	**252,989**	**8,056**	**1,107,855**	**22,548**	**1,130,403**
Deposits from customers	275,265	164,738	101,417	42,566	-	583,986	(5,027)	578,959
Other liabilities	1,453	2,811	3,199	345,375	2,317	355,155	19,976	375,131
Total segment liabilities	276,718	167,549	104,616	387,941	2,317	939,141	14,949	954,090
Allocated equity	24,582	37,304	57,200	48,982	646	168,714	7,599	176,313
Risk exposure amount	**164,795**	**239,073**	**360,923**	**61,986**	**3,316**	**830,093**	**15,856**	**845,949**

Personal Banking

Operating income for Personal Banking decreased by ISK 1,056 million, or 7.0%, to ISK 14,103 million for the year ended 31 December 2020 from ISK 15,159 million for the year ended 31 December 2019. This decrease was primarily due to COVID-19 related issues, including but not limited to a decrease in tourism-related net fee and commission income, as before 2020, high levels of tourism drove income in currency sales and cash in foreign remuneration. Moreover, a high percentage of credit card income relies on foreign turnover which decreased by a huge margin as worldwide travel decreased significantly. The margin of deposits also decreased considerably when central rates were lowered, resulting in most external rates equalling zero.

Operating income for Personal Banking increased by ISK 648 million, or 4.5%, to ISK 15,159 million for the year ended 31 December 2019 from ISK 14,511 million for the year ended 31 December 2018. This increase was primarily due to an increase in mortgage portfolio balance and mortgage portfolio margins.

The cost-income ratio for the Personal Banking division amounted to 74.8% in 2018, 73.0% in 2019 and 72.0% in 2020. The high focus on digital solutions has resulted in more streamlined operations and reduced costs, in part driven by FTE reductions. However, there were significant investments in digital solutions from 2018 through the first quarter of 2020. The cost-income ratio in 2020 was negatively impacted by the reduction in net fee and commission income.

Loans in the Personal Banking division increased from ISK 299 billion as at 31 December 2018 to ISK 329 billion as at 31 December 2019 and ISK 420 billion as at 31 December 2020, while margins on loans amounted to 1.3% in 2018, 1.2% in 2019 and 1.7% in 2020. Expansion in the loan book has been driven by continued growth in new mortgage lending, with exceptional growth seen in the second half of 2020, significantly in excess of GDP growth, which is not expected to be repeated.

The Bank anticipates continued strong loan growth, with mortgages expected to remain the main driver of loan book growth in the Personal Banking division.

Deposits in the Personal Banking division have typically grown in line with loans, increasing from ISK 275 billion as at 31 December 2018 to ISK 291 billion as at 31 December 2019 and ISK 325 billion as at 31 December 2020, but the strong annual growth in loans in 2020 outpaced the healthy deposit growth in the same period, resulting in loan to deposit ratios of 108.8% in 2018, 113.2% in 2019 and 129.3% in 2020 (excluding mortgages, 18.2% in 2018, 16.4% in 2019 and 13.2% in 2020). The Bank expects the loan to deposit ratio to be stable once the mortgage market normalises and deposits to grow in line with the loan book.

Net impairments in the Personal Banking division amounted to a positive impairment of ISK 0.6 billion in 2018 and impairments of ISK 0.5 billion in each of 2019 and 2020, with cost of risk amounting to -0.19% in 2018, 0.17% in 2019 and 0.14% in 2020. There is a favourable outlook for impairments in the short term due to a conservative LTV distribution and rising housing prices.

Return on equity for the Personal Banking Division amounted to 11.4% in 2018, 7.6% in 2019 and 6.2% in 2020. Return on equity suffered in 2020 as a result of the decrease in net fee and commission income attributable to COVID-19. Allocated equity increases to the division have been in line with growth of the loan book. Return on equity in 2018 was impacted by positive impairments of ISK 0.6 billion.

Business Banking

Operating income for the Business Banking division decreased by ISK 50 million, or 0.4%, to ISK 12,503 million for the year ended 31 December 2020 from ISK 12,553 million for the year ended 31 December 2019. This decrease was primarily due to lower interest income on equity and lower margins on deposits. Ergo generated 18% of Business Banking income in 2020.

Operating income for the Business Banking division increased by ISK 1,247 million, or 11.0%, to ISK 12,553 million for the year ended 31 December 2019 from ISK 11,306 million for the year ended 31 December 2018. This increase was primarily due to higher loan portfolio balance, higher margins on loans, and higher net fee and commission income.

Expansion of net interest margin and loan growth, as outlined below, are expected to drive net interest income, and net fee and commission income is expected to grow steadily.

The cost-income ratio for the Business Banking division amounted to 56% in 2018, 55% in 2019 and 50% in 2020, driven by the decrease in FTEs, structural changes and increased digitisation. The digital transformation and recent structural changes with a stable cost base, lower FTEs and higher income should anticipate the Bank for further efficiency increases. Currently, investment is underway in new systems for loans and collections and the platform.

Operating income per FTE in the Business Banking division has increased from ISK 79 million in 2018 to ISK 95 million in 2019 and ISK 104 million in 2020, reflecting the acceleration of digital solutions and digital channels in 2020 and further utilisation and development of omni-channel platforms supporting future growth.

Similarly, assets per FTE in the Business banking division increased from ISK 1,530 million as at 31 December 2018 to ISK 1,749 million as at 31 December 2019 and ISK 1,930 million as at 31 December 2020.

Loans in the Business Banking division increased from ISK 220 billion as at 31 December 2018 to ISK 231 billion as at 31 December 2019 and ISK 233 billion as at 31 December 2020. Growth in 2020 exceeded GDP despite the negative impact of COVID-19 and demonstrated the well-diversified lending portfolio of the division. Net interest margin on loans developed from 2.4% in 2018 to 2.6% in 2019 and 3.3% in 2020. Considering the increase in 2020, some decline in loan margins is probable, but expected to stabilise at a higher margin than 2018 and 2019 levels.

The Bank anticipates that the strong economic foundation in Iceland will support future loan growth in line with GDP and has a positive outlook in all sectors as well as expected upside in new lending to tourism once travel restrictions relating to COVID-19 have been lifted, with COVID-19 effects on the loan book mostly isolated to the tourism sector.

Deposits in the Business Banking division have grown steadily from ISK 165 billion as at 31 December 2018 to ISK 168 billion as at 31 December 2019 and ISK 190 billion as at 31 December 2020. System-wide deposit growth in 2020 as a result of COVID-19 is expected to stabilise, and deposits are expected to grow in line with GDP like the loan book. Net interest margin on deposits developed from 2.0% in 2018 to 2.1% in 2019 and 1.4% in 2020. Although policy interest rate cuts occurred in 2019 and 2020, higher loan margins offset the loss in deposit margins. Margin improvements on deposits are expected as interest rates rise again.

Net impairments in Business Banking amounted to a positive impairment of ISK 1.0 billion in 2018, an impairment of ISK 1.1 billion in 2019 and an impairment of ISK 5.5 billion in 2020, of which ISK 4.3 billion relates to the impact from COVID-19 on the portfolio, primarily related to tourism, with cost of risk amounting to -0.43% in 2018, 0.48% in 2019 and 2.31% in 2020. Cost of risk is expected to normalise going forward. Strong economic foundations and robust loan portfolio should enable resilient recovery.

Return on equity for the Business Banking Division amounted to 11.1% in 2018, 7.9% in 2019 and 0.6% in 2020. Return on equity suffered in 2020, as a result of increased impairments attributable to COVID-19. Adjusting for the effects of COVID-19, return on equity in 2020 was 8.8%. The Business Banking division is a profitable business unit with healthy growth, cost efficiency and normalisation in loan impairments. Return on equity increase is expected to be supported by economic recovery and efficiency gains.

Corporate & Investment Banking

Operating income for Corporate & Investment Banking increased by ISK 1,036 million, or 8.3%, to ISK 13,527 million for the year ended 31 December 2020 from ISK 12,491 million for the year ended 31 December 2019. This increase was primarily due to a disciplined pricing strategy in lending resulting in an increase in net interest income, a strong year in Corporate Finance and a dividend from Iceland Funds.

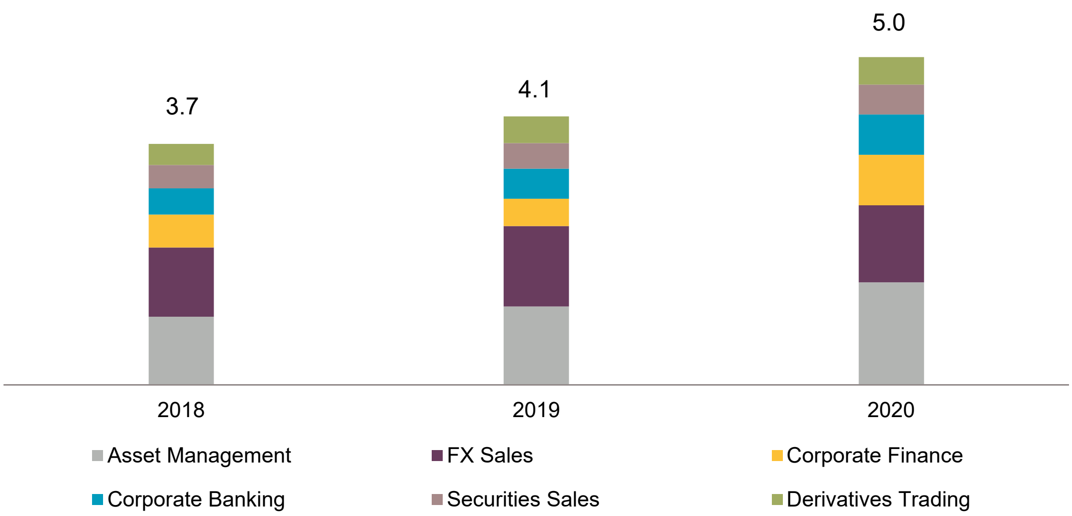
Operating income for Corporate & Investment Banking increased by ISK 1,141 million, or 10.1%, to ISK 12,491 million for the year ended 31 December 2019 from ISK 11,350 million for the year ended 31 December 2018. This increase was primarily due increase in net interest income on loans, brokerage was also profitable and there was a dividend income from Iceland Funds.

Net interest margin on loans for Corporate & Investment Banking increased from 1.4% in 2018 to 1.6% in 2019 and 2.0% in 2020, as a result of market discipline and focus on strategic pricing, while net interest margin on deposits for Corporate and Investment Banking decreased from 1.1% in 2018 to 1.0% in 2019 and 0.7% in 2020, due to lower policy rates. Margin improvements on deposits are expected as interest rates rise, and the Bank also anticipates modest margin increases on the loan portfolio. In 2020, 40% of the division's loan portfolio was on interest rate reset, and a further 30% of the portfolio is to be reset in each of 2021 and 2022.

The increase in net interest margins on loans, as well as loan portfolio growth, led to an increase in net interest income for the division despite impact of lower policy rates on allocated equity and deposits, from ISK 7.7 billion in 2018 to ISK 8.4 billion in 2019 and ISK 8.5 billion in 2020. Higher policy rates, continued margin expansion and robust loan growth are expected to drive net interest income; however, margin expansion is expected to continue at a lower rate than historical expansion rates.

Net fee and commission income and other income for the division increased from ISK 3.7 billion in 2018 to ISK 4.1 billion in 2019 and ISK 5.0 billion in 2020, reflecting strong momentum across the division's products and services. 2020 in particular was an exceptional year in Corporate Finance, and Asset Management benefited from an extra dividend received from Iceland Funds.

The graph below shows a breakdown of the contributions to net fee and commission income and other income of each of the units, in billions of ISK, for the periods under review.



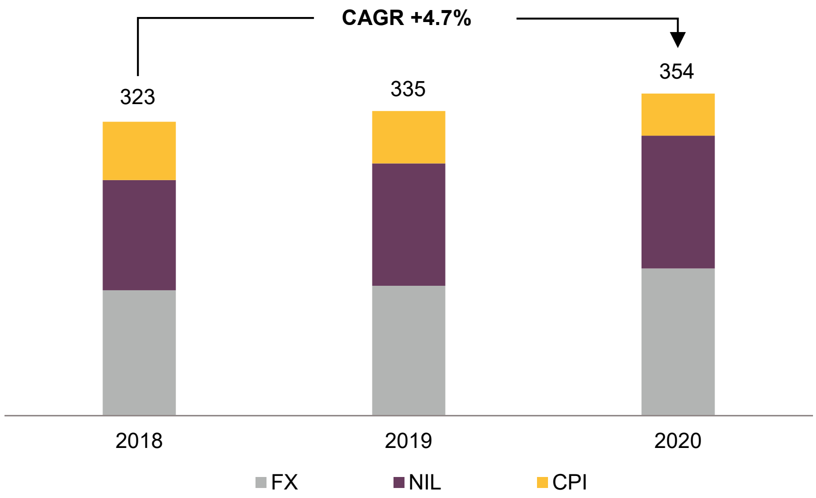
Net fee and commission income and other income for the division are expected to be impacted in the near-term, due to the effects of COVID-19 on foreign exchange sales. Corporate Finance and Asset Management are expected to normalise and then grow steadily, while other income streams are expected to provide additional growth.

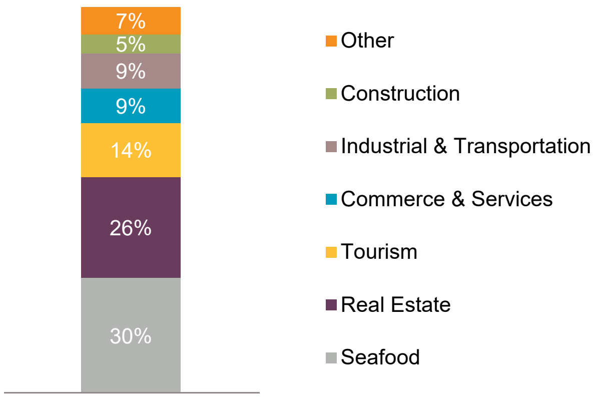
Total administrative expenses for the division increased from ISK 2.3 billion in 2018, ISK 2.4 billion in 2019 and ISK 2.5 billion in 2020, of which ISK 1.6 billion, ISK 1.7 billion and ISK 1.6 billion, respectively, comprised salaries and related expenses. Salary costs in 2020 included the full effect of the reduction in the number of employees in the division in 2019. COVID-19 had an immaterial net impact on costs in 2020. Going forward, costs are expected to increase in line with inflation.

The cost-to-income ratio for the division amounted to 44.8% in 2018, 47.2% in 2019 and 40.7% in 2020. The cost-to-income ratio is expected to improve further in the medium term on the back of the stable cost base and efficiency gains through increased use of digital solutions.

Loans in Corporate & Investment Banking increased from ISK 323 billion as at 31 December 2018 to ISK 335 billion as at 31 December 2019 and ISK 354 billion as at 31 December 2020. Growth of the loan portfolio is expected to continue in line with GDP.

The graphs below present the breakdown of the loan portfolio for the division by structure (foreign exchange, ISK-non-index-linked and ISK-CPI-linked) and sector in billions of ISK as at 31 December 2018, 2019 and 2020.





The impact of COVID-19 on the loan portfolio has mostly been limited to the tourism industry and companies relying heavily on tourism. Loans granted the COVID-19 moratorium amounted to 19% of the division's loan portfolio as at 31 December 2020, of which 5% related to government-owned entities and 7% related to loans on which interest was paid and there was a moratorium on instalments. The remaining 7% related to loans on which there was a full moratorium on payments, for which the gross carrying amount was ISK 27 billion, impairments amounted to ISK 1.3 billion and a collateral coverage ratio of around 150%. The Bank expects that the moratorium will be revisited in the third quarter of 2021, and the amount under moratorium will gradually decrease as of the third quarter of 2021.

Net impairments in Corporate & Investment Banking amounted to a positive impairment of ISK 0.2 billion in 2018, an impairment of ISK 1.0 billion in 2019 and an impairment of ISK 2.8 billion in 2020, of which ISK 1.8 billion relates to the impact from COVID-19 on the portfolio, primarily related to tourism, with cost of risk amounting to -0.05% in 2018, 0.31% in 2019 and 0.80% in 2020. Cost of risk is expected to normalise going forward.

Return on equity for the division amounted to 7.7% in 2018, 6.2% in 2019 and 5.4% in 2020. Return on equity suffered in 2020, as a result of increased impairments attributable to COVID-19. Adjusting for the effects of COVID-19, return on equity in 2020 was 7.6%. Loan portfolio growth, margin improvements and cost efficiency are expected to deliver return on equity expansion.

Treasury & Proprietary Trading

Operating income for Treasury & Proprietary Trading decreased by ISK 88 million, or 4.2%, to ISK 1,997 million for the year ended 31 December 2020 from ISK 2,085 million for the year ended 31 December 2019. This decrease was primarily due to a lower interest environment, which was offset by fair value adjustments of an investment in the investment book.

Operating income for Treasury & Proprietary Trading decreased by ISK 2,525 million, or 54.8%, to ISK 2,085 million for the year ended 31 December 2019 from ISK 4,610 million for the year ended 31 December 2018. This decrease was primarily due to lower profit of assets in the investment book. In 2018, a few assets were sold at a considerable profit while in 2019 there was less activity in the investment book.

Cost Centres

Operating income for Cost centres decreased by ISK 1,874 million, or 96.0%, to ISK 79 million for the year ended 31 December 2020 from ISK 1,953 million for the year ended 31 December 2019. This decrease was primarily due to a one-off item recorded in 2019, a settlement of the Bank's claim deriving from the acquisition of Byr savings bank in 2011 and a reversal of a previously expensed contribution to the Depositors' and Investors' Guarantee Fund relating to past changes in the legislation on deposit insurance.

Operating income for Cost centres increased by ISK 1,877 million, or 2,469.7%, to ISK 1.953 million for the year ended 31 December 2019 from ISK 76 million for the year ended 31 December 2018. This increase was primarily due to a one-off item recorded in 2019, a settlement of the Bank's claim deriving from the acquisition of Byr savings bank in 2011 and a reversal of previously expensed contribution to the Depositors' and Investors' Guarantee Fund relating to past changes in the legislation on deposit insurance.

Operating expenditures and capital expenditures for IT, on a cash basis, amounted to ISK 5,849 million in 2018 and decreased to ISK 5,496 million in 2019 and ISK 4,553 million in 2020. Operating expenditure and depreciation amounted to ISK 5,587 million in 2018, ISK 5,857 million in 2019 and ISK 4,844 million in 2020. This reflects an overall reduction in IT costs over the period, with further reductions expected in 2021. Capital investments in 2020 amounted to 20% of the peak in 2017, and cost reductions have been achieved through automation and optimisation of delivery processes, as well as implementation of an extended delivery model allowing for sourcing development capacity from cost-effective locations. The Bank expects IT operating expenditures to stabilise going forward.

Subsidiaries, Eliminations & Adjustments

Operating income for subsidiaries, eliminations & adjustments increased by ISK 20 million, or 2.2%, to ISK 944 million for the year ended 31 December 2020 from ISK 924 million for the year ended 31 December 2019. This increase was primarily due to an increase in net fee and commission income in Iceland Funds.

Operating income for subsidiaries, eliminations & adjustments decreased by ISK 2,210 million, or 70.5%, to ISK 924 million for the year ended 31 December 2019 from ISK 3,134 million for the year ended 31 December 2018, primarily as a result of the presentation of 2019 figures excluding the impact of Borgun. Excluding the impact of Borgun on 2018 and 2019, operating income for subsidiaries, eliminations & adjustments increased by ISK 603 million, or 187.9%, to ISK 924 million for the year ended 31 December 2019 from ISK 321 million for the year ended 31 December 2018. This increase was primarily due to an increase in net fee and commission income in Allianz Ísland hf. and Iceland Funds.

Fee and commission income for Iceland Funds has increased at a compound annual growth rate of 10.4% from 2016 (ISK 1,120 billion) through 2020 (ISK 1,664 billion), reflecting stable growth of core products, while the increase in assets under management has been driven by successful development of new funds, an increasing number of clients across all segments as well as inflows from existing clients. Over the period, mature alternative products have been replaced through product development.

The cost-to-income ratio for Iceland Funds decreased by 22.3 percentage points from 2016 (89.7%) to 2020 (67.4%), driven by a largely fixed cost base in combination with increasing fee and commission income.

As a result of the foregoing, profit before tax for Iceland Funds increased at a compound annual growth rate of 49.4% from 2016 (ISK 121 million) to 2020 (ISK 602 million), and return on equity increased by 17.5 percentage points, from 4.3% in 2016 to 21.9% in 2020.

Iceland Funds sees future growth through continued asset development, an expanded customer base, further digitisation and product development responsive to investor needs with sustainable investment solutions.

Cash Flows

The table below sets forth the Group's cash flows for the periods indicated.

	Year ended 31 December		
	2020	2019	2018
	(ISK in millions)		
Net cash (used in) provided by operating activities	(80,724)	18,333	(101,519)
Net cash (used in) provided by investing activities	(2,964)	(552)	3,291
Net cash (used in) provided by financing activities	46,715	(8,281)	54,186
Net increase (decrease) in cash and cash equivalents	(36,973)	9,500	(44,042)
Cash and cash equivalents at beginning of the year	152,481	143,203	187,438
Effects of foreign exchange rate changes	160	(222)	(193)
Cash and cash equivalents at year-end	**115,668**	**152,481**	**143,203**

Net cash (used in) provided by operating activities

Net cash (used in) provided by operating activities increased by ISK 99,057 million, or 540.3%, to negative ISK 80,724 million for the year ended 31 December 2020 from positive ISK 18,333 million for the year ended 31 December 2019. This increase was primarily due to growth in loans to customers and growth in bonds and debt instruments, following the Central Bank of Iceland's decision to stop offering 30-day deposits in May 2020.

Net cash (used in) provided by operating activities decreased by ISK 119,852 million, or 118.1%, to positive ISK 18,333 million for the year ended 31 December 2019 from negative ISK 101,519 million for the year ended 31 December 2018. This decrease was primarily due to a slower growth in loans to customers, growth in deposits and positive cash flows from bonds and debt instruments, offset by a change in net impairment of financial assets from positive to negative increasing non-cash items included in profit or loss.

Net cash (used in) provided by investing activities

Net cash (used in) provided by investing activities increased by ISK 2,412 million, or 437.0%, to negative ISK 2,964 million for the year ended 31 December 2020 from negative ISK 552 million for the year ended 31 December 2019. This increase was primarily due to effects from a sale of a subsidiary where cash owned by the subsidiary was derecognised from the accounts of the Group.

Net cash (used in) provided by investing activities decreased by ISK 3,843 million, or 116.8%, to negative ISK 552 million for the year ended 31 December 2019 from positive ISK 3,291 million for the year ended 31 December 2018. This decrease was primarily due to effects from sale and liquidation of subsidiaries. In 2018 the Group sold one of its subsidiaries and two were liquidated with positive cash effects.

Net cash (used in) provided by financing activities

Net cash (used in) provided by financing activities increased by ISK 54,996 million, or 664.1%, to positive ISK 46,715 million for the year ended 31 December 2020 from negative ISK 8,281 million for the year ended 31 December 2019. This increase was primarily due to the issuance of new debt securities and due to no dividend payments being made during the year 2020 because of uncertainties following COVID-19.

Net cash (used in) provided by financing activities decreased by ISK 62,467 million, or 115.3%, to negative ISK 8,281 million for the year ended 31 December 2019 from positive ISK 54,186 million for the year ended 31 December 2018. This decrease was primarily due to higher repayments of borrowings during the year 2019 compared to the previous year although offset by a lower dividend between years.

Funding

The funding policy of the Group is to seek stable funding at low cost, which provides the Group with a competitive advantage in the Icelandic banking market to service its retail and corporate customers. The Group's funding profile is strong and supports the Group's liquidity profile, helps to withstand stress scenarios for an extended period of time and does not rely on volatile funding or external support. The funding policy also helps to support the franchise value of the Bank, as it aims to be a leading issuer of debt in Iceland by having good investor relations, disclosure and credit ratings.

The Group is focused on maintaining a large and stable deposit base originated from its customers. Deposits are expected to continue to form the core of the Group's funding profile in the future. However, there are external factors that might affect the Group's deposit base in the short to medium term, such as the increased availability of other investment opportunities for investors who currently hold deposits with the Group.

In addition to deposits, the Group has gradually been increasing its borrowing in recent years with the issuance of covered bonds and unsecured bonds in foreign and local currencies, as well as subordinated debt.

Deposit Funding

The Group is partially funded with domestic deposits. Its total deposit base as at 31 March 2021 was ISK 730 billion or 61% of its total liabilities. As at 31 March 2021, the aggregate amount of the Group's 10 largest deposits equalled 15% of the aggregate amount of the Group's total deposits as at such date.

In the periods under review, the Group has experienced a stable concentration of deposits, while average deposit yields decreased from 2.8% for the year ended 31 December 2018 to 2.5% for the year ended 31 December 2019, due to lower policy rates.

For the year ended 31 December 2020, the rate was 1.2%, and the decrease compared to the year ended 31 December 2019 was mainly due to lower policy rates.

The table below sets forth the composition of the Group's deposits from customers as at the dates indicated.

	As at 31 March	As at 31 December		
	2021	**2020**	**2019**	**2018**
		(ISK in millions)		
Central government and state-owned enterprises	9,739	8,145	12,553	9,331
Municipalities	11,088	7,561	5,619	5,574
Companies	332,439	326,799	299,204	278,209
Individuals	345,309	336,950	300,937	285,845
Deposits from customers	**698,575**	**679,455**	**618,313**	**578,959**

Although the Group has a stable deposit base which it expects to grow over time, it continues to diversify its funding profile to reduce asset and liability mismatches and have a balanced maturity profile in order to manage its liquidity risk. For additional information on the Group's deposits, see "*Risk Management—Liquidity and Funding Risk.*"

Debt Issued and Other Borrowed Funds

The tables below set forth the Group's non-deposit debt issued and other borrowed funds as at the dates indicated:

				As at 31 March	As at 31 December		
	Issued	**Maturity**	**Interest**	**2021**	**2020**	**2019**	**2018**
Covered bonds in ISK	2014-2017	2019 At maturity	Fixed rates	-	-	-	9,866
Covered bonds in ISK	2019-2020	2021 At maturity	Fixed rates	4,992	5,076	3,918	-
Covered bonds in ISK	2015-2020	2023 At maturity	Fixed rates	30,095	29,496	20,170	10,890
Covered bonds in ISK	2012-2014	2019 At maturity	Fixed rates	-	-	-	8,937
Covered bonds in ISK	2020	2027 Amortising	Fixed rates	13,035	5,386	-	-
Covered bonds in ISK – CPI-linked	2014-2015	2020 At maturity	Fixed rates	-	-	4,359	4,248
Covered bonds in ISK – CPI-linked	2015-2017	2022 At maturity	Fixed rates	19,250	19,228	18,512	18,009
Covered bonds in ISK – CPI-linked	2012-2018	2024 At maturity	Fixed rates	36,596	36,797	35,752	35,009
Covered bonds in ISK – CPI-linked	2015-2018	2026 At maturity	Fixed rates	28,986	28,571	27,661	26,992
Covered bonds in ISK – CPI-linked	2019-2020	2028 Amortising	Fixed rates	24,107	25,606	14,228	-
Covered bonds in ISK – CPI-linked	2017-2018	2030 At maturity	Fixed rates	26,588	26,285	25,463	24,862
Covered bonds				**183,649**	**176,445**	**150,063**	**138,813**
Senior unsecured bonds in SEK	2015	2019 At maturity	Fixed rates	-	-	-	7,844
Senior unsecured bonds in EUR	2017	2019 At maturity	Fixed rates	-	-	-	4,398
Senior unsecured bonds in SEK	2018	2019 At maturity	Fixed rates	-	-	-	1,302
Senior unsecured bonds in EUR**	2016	2020 At maturity	Fixed rates	-	-	7,782	68,154
Senior unsecured bonds in SEK	2018	2020 At maturity	Fixed rates	-	-	-	3,259
Senior unsecured bonds in SEK*	2019	2020 At maturity	Floating rates	-	-	4,557	-
Senior unsecured bonds in SEK	2018	2021 At maturity	Fixed rates	-	1,553	1,308	1,311
Senior unsecured bonds in SEK*	2018	2021 At maturity	Floating rates	13,775	14,832	6,512	2,613
Senior unsecured bonds in SEK*	2018-2019	2021 At maturity	Floating rates	-	6,630	12,401	12,440
Senior unsecured bonds in EUR	2019	2021 At maturity	Floating rates	1,704	1,795	1,559	-
Senior unsecured bonds in SEK	2018	2022 At maturity	Floating rates	14,474	15,574	12,990	12,995
Senior unsecured bonds in EUR**	2019	2022 At maturity	Fixed rates	45,014	47,494	41,570	-
Senior unsecured bonds in NOK	2019	2022 At maturity	Floating rates	14,875	14,982	13,856	-
Senior unsecured bonds in EUR***	2018	2024 At maturity	Fixed rates	45,104	48,032	41,816	40,714
Senior unsecured bonds in NOK	2019	2024 At maturity	Fixed rates	5,966	6,187	5,709	-
Senior unsecured bonds in ISK	2019	2024 Monthly	Floating rates	2,493	2,664	3,553	-
Senior unsecured bonds in EUR**	2020	2023 At maturity	Fixed rates	44,889	46,944	-	-
Senior unsecured bonds in ISK	2020	2025 At maturity	Fixed rates	2,732	2,709	-	-
Senior unsecured bonds in NOK	2021	2024 At maturity	Floating rates	2,222	-	-	-
Senior unsecured bonds in SEK	2021	2024 At maturity	Floating rates	3,615	-	-	-
Senior unsecured bonds in NOK	2021	2025 At maturity	Floating rates	11,103	-	-	-
Senior unsecured bonds in SEK	2021	2025 At maturity	Floating rates	6,504			
Bonds issued				**214,470**	**209,396**	**153,613**	**155,030**
Bills issued and other debt securities				-	**1,433**	**2,705**	**6,729**
Other debt securities				106	**-**	**-**	**404**
Debt issued and other borrowed funds				**398,225**	**387,274**	**306,381**	**300,976**

*The Bank repurchased own bonds during the year 2020 amounting to ISK 6,084 million.
**These bond issuances are classified as being designated as at fair value through profit or loss. As at 31 December 2020 the total carrying amount of the bonds amounted to ISK 94,438 million and included in the amount are fair value changes amounting to ISK 729 million. The carrying amount of the bonds at 31 December 2020 was ISK 16 million higher than the contractual amount due at maturity.
***The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments. The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in EURIBOR benchmark interest rates. The Group applies fair value hedge accounting to the hedging relationships and for the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of IBOR reform. As at 31 December 2020 the total carrying amount of the bond issuance amounted to ISK 48,032 million and included in the amount are fair value changes amounting to ISK 824 million.
The Bank has issued additional covered bonds for its own use, for example for the purpose of securities lending with regards to market making agreements. These covered bond amounts are not included in the total.

Covered Bonds

The Bank has established a covered bond programme, issued under Act No. 11/2008, under which it issues covered bonds on a regular basis to finance its residential mortgage lending. The covered bonds may be either rated or unrated, have either fixed or floating interest rates and may be linked to a currency or CPI. As at 31 December 2020, the covered bonds covered 12,269 loans with an asset balance of ISK 234 billion, a pool loan-to-value ratio of 55.0% and over-collateralisation of 27.5%. The Bank expects a majority of covered bonds issued in the short to medium term to be non-index linked given the preference of the borrowers for lower interest rates.

The covered bond issuance will depend largely on the Bank's mortgage loan growth as well as on upcoming maturities. The Bank estimates that the total sale of covered bonds will be ISK 30-35 billion during 2021.

Senior Unsecured Debt

The Bank has issued senior unsecured bonds under its domestic bond programme as well as the Banks GMTN Programme.

Domestic Bond Programme

Under the domestic bond programme, the Bank is able to issue a wide range of bonds in ISK, including commercial paper and unsecured bonds. Total bonds issued under the domestic bond programme increased by ISK 0.5 billion to ISK 6.8 billion as at 31 December 2020 from ISK 6.3 billion as at 31 December 2019. This increase was primarily due to the Bank issuing the first green bond in ISK, an issuance of an ISK 2.7 billion

3.5% five-year fixed rate bond. The Bank plans to continue its issuance of senior bonds in ISK in a continued effort of developing and promoting the domestic bond market.

Global Medium-Term Note programme

The Bank's GMTN programme is the Bank's platform for funding in international markets. The programme is registered at the Irish Stock Exchange and is rated by S&P, with a rating matching the Bank's.

Total unsecured debt issued under the GMTN increased by ISK 53.9 billion, or 36.0%, to ISK 204 billion as at 31 December 2020 from ISK 150 billion as at 31 December 2019. This increase was primarily due to the Bank issuing its first EUR 300 million benchmark green bond having just signed its Sustainable Financing Framework in November 2020. The bond carries a term of three years and was offered through lead managers ABN AMRO, Barclays, Goldman Sachs and UBS. The offering was three-times oversubscribed, acquired by over 80 European investors, and priced at mid-swaps +100 basis points and placed with investors across Europe. This transaction was followed by a green bond, ISK 2.7 billion 5-year senior issue in the local market, which was the first green bond issued by an Icelandic bank.

This issuance was Iceland's inaugural EUR sustainable bond, built on Green and Social Bond Principles and the Sustainability Bond Guidelines issued by the International Capital Markets Association and was three times oversubscribed at the time of issuance and acquired by over 80 European investors.

Future issuances of unsecured bonds will depend largely on the Bank's loan growth and on upcoming maturities.

Subordinated Loans

Subordinated loans include Tier 2 and can be issued under the GMTN programme in foreign and domestic currency. The Bank's Tier 2 capital increased from ISK 23 billion in the year ended 31 December 2019 to ISK 27 billion in the year ended 31 December 2020 due to the depreciation of the ISK against the SEK. All the Bank's Tier 2 issuance is denominated in SEK. The part of the total SREP capital requirement that can be met with tier 2 subordinated debt is currently fully utilised. The Bank is contemplating issuing additional Tier 1 capital instruments in foreign or local currency in order to continue to optimise the Bank's capital structure.

The table below sets forth the Group's subordinated loans as at the dates indicated:

				As at 31 December		
	Issued	**Maturity**	**Interest**	**2020**	**2019**	**2018**
					(ISK in millions)	
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	Floating, STIBOR +2.0%	11,646	9,714	9,724
Subordinated loans in SEK	2018	2028	Floating, STIBOR +2.5%	7,775	6,485	6,492
Subordinated loans in SEK	2019	2029	Floating, STIBOR +3.9%	7,773	6,475	–
Subordinated loans..				**27,194**	**22,674**	**16,216**

Liquidity

The Group 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. Sound and efficient management of liquidity risk is a key factor to ensure the viability of the Bank's operations and to achieve and maintain a target credit rating. The Bank takes a conservative and prudent approach to managing liquidity risk and its liquidity strategy assumes that the Bank always fulfils regulatory requirements, internal thresholds and can sustain a prolonged period of stress.

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

See "*Risk Factors-Risk Relating to Business and Industry-The Bank is exposed to liquidity risk.*" For additional information on the composition of the Group's funding and deposit base, see "*—Funding" and "Risk Management—Liquidity and Funding Risk.*"

Key measures for the assessment of liquidity risk are the LCR and NSFR. The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the

CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the FSA guidelines No. 2/2010 on best practices in liquidity management and liquidity coverage ratio Rules No. 266/2017. The LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions. The LCR is defined as the quotient of the weighted liquid assets divided by the difference between the weighted cash outflows and the weighted cash inflows, where weighted cash inflows are capped at 75% of weighted cash outflows. For additional information, see the note titled "*Liquidity risk*" in the Annual Financial Statements of the relevant year.

Highly liquid assets under the LCR Rules, include cash and balances with the Central Bank of Iceland, domestic bonds eligible as collateral against borrowing at the Central Bank of Iceland, and foreign government bonds in accordance with Rules No. 266/2017 on liquidity ratio. The Central Bank of Iceland has issued rules for minimum LCR. The LCR requirements are 100% for all currencies and foreign currency. Additionally a requirement of 30% in domestic currency came into force on 1 January 2020, increasing to 40% in 2022 and finally reaching the full 50% at the beginning of 2023. The Bank reports the LCR to the Central Bank of Iceland on a monthly basis.

The table below sets forth the LCR as at the dates indicated.

	As at 31 March 2021	As at 31 December		
		2020	2019	2018
For all currencies	172%	196%	155%	172%
Domestic currency	93%	95%	110%	Not provided
Foreign currencies	235%	463%	325%	544%

The Group's liquidity reserve, measured as the total of liquid assets, amounted to ISK 196,752 million as at 31 December 2020, representing 27.4% of deposits as at 31 December 2020 (ISK 169,022 million as at 31 December 2019 and ISK 171,971 million as at 31 December 2018). The Group's loan-to-deposit ratio as at 31 December 2020 was 140.0% (115.4% excluding covered bonds), as compared to 138.6% as at 31 December 2019 (115.5% excluding covered bonds) and 142.4% as at 31 December 2018 (119.0% excluding covered bonds). The Bank expects an increased loan-to-deposit ratio going forward, as the customer loan portfolio is expected to grow faster than deposits.

The table below sets forth the calculation of the loan-to-deposit ratio excluding covered bonds, which is non-IFRS information.

	As at 31 March 2021	As at 31 December		
		2020	2019	2018
	(ISK in millions, except percentages)			
Loans to customers	1,029,415	1,006,717	899,632	846,599
Covered bonds	**183,649**	**176,445**	**150,063**	**138,813**
Loans to customers excluding covered bonds	**845,766**	**830,272**	**749,569**	**707,786**
Deposits	730,140	719,213	649,238	594,578
Loan-to-deposit ratio	**141.0%**	**140.0%**	**138.6%**	**142.4%**
Loan-to-deposit ratio excluding covered bonds	**115.8%**	**115.4%**	**115.5%**	**119.0%**

The Group considers liquidity risk as a key risk factor and places emphasis on managing it. For additional information on the Group's liquidity, including liquidity risk, see "*Risk Management—Liquidity and Funding Risk.*"

Capital Position

The Group aims at managing its capital position and the corresponding capital ratios at a margin above the overall regulatory capital requirement. The resulting long-term capital target assumes that the Bank maintains a capital management buffer of about 0.5–2.0% in excess of the overall capital requirements, of which the CET1 ratio shall exceed 16%. The Bank's target dividend pay-out ratio is approximately 50% of after-tax profits of the preceding year. It is the Bank's intention to optimise the capital structure by issuing AT1 instruments in the medium term and distribute the resulting capital surplus to shareholders.

Capital Ratios

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through the Financial Undertakings Act and Regulation No. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

For additional information, see "*Regulatory Overview—Principal Legislation and Regulations—Capital Requirements Directive*".

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the FSA, applicable as at 22 September 2020, the total capital requirement is 9.7% and the overall capital requirement is 17.0%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The table below sets out the capital ratios of the Group.

	As at 31 March	As at 31 December		
	2021	**2020**	**2019**	**2018**
	(ISK in millions, except percentages)			
CET1 capital				
Ordinary share capital	10,000	10,000	10,000	10,000
Share premium	55,000	55,000	55,000	55,000
Reserves	6,353	6,181	7,065	6,499
Retained earnings	113,335	113,529	105,569	102,496
Non-controlling interests	783	1,494	2,428	2,318
IFRS 9 reversal due to transitional rules	3,853	5,164	-	-
Fair value changes due to own credit standing	434	238	392	376
Expected or proposed dividend payment	(1,725)	-	-	-
Tax assets	(1,087)	(259)	(476)	(215)
Intangible assets	(3,357)	(3,478)	(4,330)	(5,002)
Total CET1 capital	**183,589**	**187,869**	**175,648**	**171,472**
Tier 2 capital				
Qualifying subordinated loans	25,259	27,194	22,674	16,216
Total capital base	**208,848**	**215,063**	**198,322**	**187,688**
Risk exposure amount				
- due to credit risk	851,309	830,141	789,180	750,801
- due to market risk	17,447	16,626	7,919	7,622
Market risk, trading book	14,062	11,306	6,488	6,649
Currency risk	3,385	5,320	1,431	973
- due to credit valuation adjustment	930	1,728	2,027	2,385
- due to operational risk	85,026	85,026	85,424	85,141
Total risk exposure amount	**954,712**	**933,521**	**884,550**	**845,949**
Capital ratios				
Tier 1 (CET1) ratio	19.2%	20.1%	19.9%	20.3%
Total capital ratio	21.9%	23.0%	22.4%	22.2%
REA density	68.9%	69.4%	73.7%	74.8%

As stated in "*Business Overview—Financial Targets*," the Bank has a medium-term target to reduce its CET1 ratio to approximately 16%, which it expects to have the most significant impact on achieving its long-term target to achieve a competitive return on equity (post-tax) exceeding 4-6% on top of risk-free rate.

As an illustrative example of how normalisation of the Group's capital structure could have an impact on return on equity, assuming a reduction of CET1 ratio from 20.1% as at 31 December 2020 to 18.1%, with a further assumption of return on equity of 6% before CET1 reduction, funding rate of 2.0% and 26% effective tax rate, the impact on profitability would be an increase of 0.50 percentage points. The impact of CET1 reduction is greater as the difference between funding rates and the ROE of the Group before CET1 reduction increases. Further capital optimisation can be reached issuing AT1 capital. The benefit of issuing AT1 capital is, however, subject to tax deductibility of those instruments and the pricing of the instruments as compared to the ROE of the Group.

This example is provided for illustrative purposes only based on assumptions the Bank's management deems reasonable at the present time and is not an indication of actual results that may be achieved if the Bank reduces its CET1 ratio.

For additional information on the Group's capital requirements, see "*Risk Management—Capital Management.*"

The table below sets forth the Group's total capital and calculations of risk-weighted assets as at the dates indicated. The information is derived from the Annual Financial Statements, the Bank's unaudited condensed consolidated interim financial statements for the three months ended 31 March 2021 and from unaudited accounting records of the Bank (in relation to the breakdown of credit risk). The Group expects growth in risk-weighted assets to be broadly in line with lending growth, and it will continue to look for ways to reduce risk-weighted asset density.

	As at 31 March 2021	As at 31 December 2020	2019	2018
	(ISK in millions, except percentages)			
Total equity	185,471	186,204	180,062	176,313
Common equity Tier 1 capital before regulatory adjustments	**185,471**	**186,204**	**180,062**	**176,313**
IFRS 9 reversal due to transitional rules	3,853	5,164	-	-
Fair value changes due to own credit standing	434	238	392	376
Expected or proposed dividend payment	(1,725)	-	-	-
Tax assets	(1,087)	(259)	(476)	(215)
Intangible assets	(3,357)	(3,478)	(4,330)	(5,002)
Common equity Tier 1 capital	**183,588**	**187,869**	**175,648**	**171,472**
Non-controlling interest not eligible for inclusion in CET1 capital	-	-	-	-
Tier 1 capital	**183,588**	**187,869**	**175,648**	**171,472**
Qualifying subordinated loans	25,259	27,194	22,674	16,216
Tier 2 capital	**25,259**	**27,194**	**22,674**	**16,216**
Total capital base	**208,847**	**215,063**	**198,322**	**187,688**
Risk-weighted assets				
Credit risk, loans (Icelandic Government and administrative bodies)	2,880	3,284	3,298	3,176
Credit risk, loans and commitments (institutions)	22,082	18,884	11,447	8,884
Credit risk, loans and commitments (corporates)	516,797	505,207	490,568	479,208
Credit risk, loans and commitments (retail)	111,264	135,315	134,262	132,890
Credit risk, loans and commitments (real estate—individuals and corporates)	129,374	106,943	81,094	74,550
Credit risk, loans and commitments (exposure in default)	22,895	30,445	27,657	17,716
Credit risk, securities and other (other assets)	25,327	13,113	16,423	14,461
Credit risk, securities and other (equity)	15,813	9,771	14,397	10,963
Credit risk, securities and other (bonds)	19	136	1,336	1,503
Credit risk (counterparty credit risk)	4,857	7,043	8,698	7,451
Total credit risk	**851,309**	**830,141**	**789,180**	**750,801**
Market risk (currency risk)	3,385	5,320	1,431	973
Market risk (trading book)	14,062	11,306	6,488	6,649
Credit valuation adjustment	930	1,728	2,027	2,385
Operational risk	85,026	85,026	85,424	85,141
Total risk-weighted assets	**954,712**	**933,521**	**884,550**	**845,949**
Capital ratios				
CET1 ratio	19.2%	20.1%	19.9%	20.3%
Tier 1 ratio	19.2%	20.1%	19.9%	20.3%
Capital adequacy ratio	21.9%	23.0%	22.4%	22.2%

Leverage Ratio

The leverage ratio is a measure supplementing the risk-based capital requirements. A lower leverage ratio indicates higher leverage. The leverage ratio is calculated by dividing Tier 1 capital by the sum of total assets and adjusted off-balance sheet exposures. According to law, the minimum leverage ratio is 3%.

The leverage ratio is calculated on the basis of the Bank's consolidated exposures as stipulated by the CRR. The table below sets forth the calculation of the Group's leverage ratio as at the dates indicated.

	As at 31 March 2021	As at 31 December		
		2020	2019	2018
		(ISK in millions, except percentages)		
On-balance sheet exposures	1,378,255	1,333,807	1,189,062	1,120,637
Off-balance sheet exposures	68,366	41,067	38,849	47,119
Derivative exposures	6,611	9,922	9,461	8,935
Leverage ratio total exposure measure	**1,453,232**	**1,384,797**	**1,237,372**	**1,176,691**
Tier 1 capital	**183,589**	**187,869**	**175,648**	**171,472**
Leverage ratio	12.6%	13.6%	14.2%	14.6%

Capital Expenditures

Capital expenditures for the Bank during the periods under review comprise mainly expenditures on fixtures, furniture and constructing new Headquarters. Capital expenditures in vehicles are sustainable green investments, such as electric cars.

The table below sets forth the components of the Group's capital expenditures for the periods indicated. There have been no material capital expenditures since 31 March 2021.

	Three months ended 31 March	Year ended 31 December		
Capital expenditures, ISK in millions	**2021**	**2020**	**2019**	**2018**
Headquarters, fixtures & furniture	0	252	53	267
Vehicles	12	7	4	19
Work of art	1	0	2	0
Capital expenditures	**13**	**259**	**59**	**286**

Working Capital Statement

It is the assessment of the Board of Directors, for and on behalf of the Bank, that at the date of this Prospectus, the Bank has sufficient working capital to fulfil its requirements for the next 12 months.

Hedging and Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. Other derivatives held are for trading or for other purposes that are insignificant.

Derivatives are classified as financial assets or financial liabilities, measured at fair value, where changes in the fair value are reflected in the consolidated income statement. Derivatives are presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities).

The Group applies fair hedge accounting to certain bond issuances and uses certain EUR denominated interest rate swaps as hedging instruments. The interest rate swaps hedge the exposure of the Group's changes in the fair value of the fixed-rate EUR denominated bond arising from changes in the EURIBOR benchmark interest rates. For the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of the IBOR reform.

For additional information on the Group's derivatives, see the notes titled "*Classification of financial assets and financial liabilities,*" "*Fair value information for financial instruments*" and "*Offsetting financial assets and financial liabilities*" in the Annual Financial Statements. See also "*Risk Management—Market Risk.*"

Off-Balance Sheet Arrangements and Financial Commitments

The table below sets forth the guarantees, undrawn overdrafts, credit card commitments, and undrawn loans commitments which the Group has granted to customers as at the dates indicated.

	As at 31 March 2021	As at 31 December 2020	2019	2018
		(ISK in millions)		
Financial guarantees	18,278	23,189	18,861	18,021
Undrawn loan commitments	60,541	40,026	35,443	49,054
Undrawn overdrafts	58,280	56,746	51,338	49,833
Credit card commitments	33,851	32,427	30,163	29,049
Off-balance sheet items	**170,950**	**152,388**	**135,805**	**145,957**

The Bank's exposure deriving from off-balance sheet items totalled ISK 152 billion as at 31 December 2020 compared to ISK 136 billion as at 31 December 2019. Guarantees, undrawn overdrafts, credit card commitments, and undrawn loan commitments balances have generally increased during the periods under review. As a part of the agreement for the sale of Borgun, the Group provided certain guarantees with regards to chargeback risk that Borgun is exposed to through its operations, which at year-end 2020 amounted to around ISK 370 million. Those guarantees are not included in the table above. For more information, see "*Legal Considerations and Supplementary Information—Material Contracts—Acquisitions and Disposals—Sale of Borgun*" and "*Risk Factors—Legal and Regulatory Risk—The Bank may be subject to ongoing, pending or threatened legal proceedings and investigations by governmental authorities*".

Quantitative and Qualitative Disclosure about Market Risk

For quantitative and qualitative disclosure about market risk, see "*Risk Management—Market Risk.*"

Significant Accounting Estimates and Judgements

Key Sources of Estimation Uncertainty

The preparation of the Annual 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. Key sources of estimation uncertainty include the allowance for credit losses, the determination of fair value of financial instruments and intangible assets. Actual results may differ from those estimates. Estimates and underlying assumptions are under constant review. Changes in accounting estimates are recognised when they occur.

The Group's key sources of estimation uncertainty are described below.

Impairment of Financial Assets

The main assumptions used for calculating the allowance for credit losses that are subject to significant judgement include the following:

- Probability of default (PD), loss given default (LGD) and exposure at default (EAD)
- Macroeconomic variables for multiple scenarios build on available information
- Assessment of significant increase in credit risk

The probability of default (PD), exposure at default (EAD), and loss given default (LGD) inputs used to estimate expected credit losses are modelled based on variables that are most closely related with credit losses in the relevant portfolio. This includes macroeconomic variables, demographic variables, variables related to past payment history among other variables. These variables are sourced both internally and externally. Significant judgements required for measuring expected credit loss (ECL) include the following:

- Determining criteria for assessing what constitutes a significant increase in credit risk
- Establishing the forward-looking scenarios and their relative weightings

- Choosing appropriate models and assumptions for the measurement of ECL

The Group has made temporary changes to the impairment model due to COVID-19. The Group's impairment process allows for temporary changes to the impairment model to account for circumstances when it becomes evident that existing or expected risk factors have not been appropriately considered in the credit risk rating or modelling process. COVID-19 has created such circumstances for the tourism industry and therefore an adjustment is warranted. To account for the material uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they have been further classified into four impact groups as described in note 51 in the Annual Financial Statements. Where the increase was found to be significant (groups 2-4), the exposure was transferred to Stage 2. In addition, an overlay factor was applied to the ECL, comparable to an increase in up to three risk classes, and a higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios. The common risk factor in tourism was found to apply to loans to customers with a net carrying amount of ISK 94,202 million and the cumulative effect of the stage transfer and credit loss overlay amounted to ISK 6,115 million.

The ARC determined that it was appropriate to adjust the weights of the scenarios due to COVID-19, generally the scenarios are weighted 25%, -50%, -25% (good, base, bad) but it was determined appropriate to set the weights at 15%, -55%, -30% for year-end 2020, as this would best represent the probability-weighted average over all possible scenarios. These weights were changed again for the end of Q1-2021, to 10%, 55%, 35% (good, base, bad).

When deciding on the appropriate weights for the three scenarios, management used sensitivity analysis that indicated that a shift of 5% weight from the baseline to the pessimistic scenario would increase the impairment allowance by ISK 500 million while a 5% shift from the baseline to the optimistic scenario would in decrease the allowance by ISK 250 million.

Substantial uncertainty remains with regards to the impact of COVID-19 on the credit quality of the Group's credit exposures in future periods and therefore the assessment of expected credit losses.

For additional information on the allowance for credit losses, see the note 67.4 titled "*Financial assets and financial liabilities*" in "*Significant Accounting Policies*" in the 2020 Annual Financial Statements.

Fair Value of Financial Instruments

The fair value of financial instruments where an active market or quoted prices are not available are decided upon by using estimation procedures. Financial instruments measured at fair value are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. Level 3 financial assets are measured at fair value using valuation techniques based on significant unobservable inputs. The valuation of Level 3 financial assets is a subjective area as the assumption on which the valuation is based on is not easily observable and subject to management's assessment. Any changes made to the evaluation criteria could have a significant impact on the Group's results and financial position.

For additional information on fair value hierarchy, see the note titled "*Fair value information for financial instruments*" in the 2020 Annual Financial Statements.

Intangible Assets

Intangible assets are amortised over four to ten years. Intangible assets are reviewed at each reporting date to determine whether there is any indication of impairment. The value in use method is used by the Group to determine the recoverable amount of intangible assets. The following relevant criteria are considered when assessing whether indications of impairment exists; a decline in the asset's market value, plans to restructure or liquidate the asset, and if the asset generates less income than anticipated.

Future Accounting Developments

At year-end 2020 a new IFRS standard and amendments to several IFRS standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Changes that are likely to affect the Group's future financial reporting are related to the Phase 2 of the Interest Rate Benchmark Reform, but no significant impact is currently expected.

For additional information on the Phase 2 of the Interest Rate Benchmark Reform, see the note titled "Changes to accounting policies" in the 2020 Annual Financial Statements.

CAPITALISATION AND INDEBTEDNESS

The table below sets forth the capitalisation and indebtedness of the Bank as at 31 March 2021. The information has been extracted from the reviewed condensed consolidated interim financial information or from the accounting records as at and for the three months ended 31 March 2021 and should be read in conjunction with "*Operating and Financial Review*" and "*Selected Consolidated Financial, Operating and Other Information*" as well as the Annual Financial Statements and the condensed consolidated interim financial information as at and for the three months ended 31 March 2021, together with the notes thereto, included elsewhere in this Prospectus.

	As at 31 March 2021
	(*ISK in millions*)
Total current debt	**43,335**
Guaranteed	—
Secured(1)	9,598
Unguaranteed/unsecured(2)	33,737
Total non-current debt (excluding current portion of long-term debt)	**380,517**
Guaranteed	—
Secured(3)	174,051
Unguaranteed/unsecured(4)	206,466
Shareholders' equity(5)	**71,353**
(a) Share capital	10,000
(b) Share premium	55,000
(c) Reserve	6,353
Total	**495,205**

(1) Current secured debt comprises of the short-term portion of covered bonds with a remaining maturity up to one year.
(2) Current unsecured debt comprises of senior unsecured debt and bank debt with maturity up to one year.
(3) Non-current secured debt comprises the long-term portion of covered bonds with a remaining maturity over one year.
(4) Non-current unsecured debt comprises of senior unsecured debt and subordinated loans with maturity over one year.
(5) Retained earnings of ISK 113 billion not included.

	As at 31 March 2021
	(*ISK in millions*)
(A) Cash and balances with Central Bank(1)	79,009
(B) Cash equivalents(2)	103,301
(C) Trading securities excluding derivatives(3)	68,568
(D) Liquidity (A) + (B) + (C)(4)	**250,878**
(E) Current bank debt(5)	474
(F) Current portion of non-current debt(6)	42,861
(G) Current financial indebtedness (E) + (F)	**43,335**
(H) Net current financial indebtedness (G) – (D)	**(207,543)**
(I) Non-current bank loans	0
(J) Bonds issued(7)	380,517
(K) Other non-current loans	0
(L) Non-current financial indebtedness (I) + (J) + (K)	**380,517**
(M) Total financial indebtedness (H) + (L)	**172,974**

(1) Cash and freely available balances at Central Bank.
(2) Bank accounts held at other credit institutions and money market loans to banks with a remaining maturity of three months or less.
(3) Securities in the liquidity portfolio and securities held for trading.
(4) Liquidity is not equal to the Bank's liquidity portfolio buffer held for liquidity contingency purposes.
(5) Current bank debt comprises of bank debt with maturity up to one year.
(6) Total of senior secured debt, senior unsecured debt and bank debt all with a remaining maturity up to one year.
(7) Total of senior secured debt, senior unsecured debt, bank debt and subordinated liabilities all with a remaining maturity over one year.

The Group has pledged assets against issued covered bonds in the form of cash and mortgage loans to individuals. Such pledged assets were a total of ISK 280 billion at 31 March 2021

Other than as disclosed in this Prospectus, there has been no material change in the capitalisation or indebtedness of the Bank since 31 March 2021.

SELECTED STATISTICAL INFORMATION

The statistical information presented below is derived from the Annual Financial Statements and the Group's financial reporting and management information systems. The statistical information below is unaudited and has been labelled accordingly when applicable.

Average Balance Sheet and Interest Information

The table below sets forth the average balances of the Group's interest-earning assets and interest-bearing liabilities, other assets and liabilities, the interest generated from such assets and liabilities and average return rate for the periods indicated. Average balances are calculated using month-end figures, including the prior year-end figures.

	Year ended 31 December								
	2020			2019			2018		
	Average balance	Interest	Yield (in %)	Average balance	Interest	Yield (in %)	Average balance	Interest	Yield (in %)
	(Unaudited, ISK millions unless otherwise stated)								
Assets									
Cash and balances with Central Bank	107,476	1,750	1.6%	128,447	4,452	3.5%	166,638	7,279	4.4%
Loans to credit institutions and customers	1,016,773	51,628	5.1%	953,448	54,837	5.8%	860,206	52,462	6.1%
Bonds and derivatives	114,414	2,314	2.0%	77,836	2,630	3.4%	56,547	1,825	3.2%
Other assets	11,952	3	0.0%	13,532	46	0.3%	12,211	109	0.9%
Total interest-earning assets	**1,250,615**	**55,695**	**4.5%**	**1,173,263**	**61,965**	**5.3%**	**1,095,602**	**61,675**	**5.6%**
Liabilities									
Total Deposits	(697,609)	(8,436)	1.2%	(629,776)	(15,867)	2.5%	(599,051)	(16,948)	2.8%
Other liabilities	(30,128)	(1,338)	4.4%	(38,428)	(2,223)	5.8%	(38,747)	(2,594)	6.7%
Borrowings	(331,090)	(11,787)	3.6%	(325,794)	(10,552)	3.2%	(281,299)	(9,998)	3.6%
Subordinated liabilities	(25,651)	(763)	3.0%	(19,576)	(501)	2.6%	(11,710)	(198)	1.7%
Total liabilities	**(1,084,478)**	**(22,324)**	**2.1%**	**(1,013,574)**	**(29,143)**	**2.9%**	**(930,807)**	**(29,738)**	**3.2%**

Investments in debt securities

As at 31 December 2020, all investments the Bank's investments in debt securities were classified at fair value. The table below sets forth the Bank's debt securities investment portfolio, as at 31 December 2020, indicating which were held at fair value through profit and loss and which were held for hedging purposes.

At 31 December 2020	**Mandatorily at FVTPL**	**Held for hedging**	**Carrying amount**
Listed bonds and debt instruments	90,603	-	90,603
Listed bonds and debt instruments used for economic hedging	37,468	-	37,468
Unlisted bonds and debt instruments	145	-	145
Derivatives	5,639	1,008	6,647
Total Debt Securities	133,855	1,008	134,863

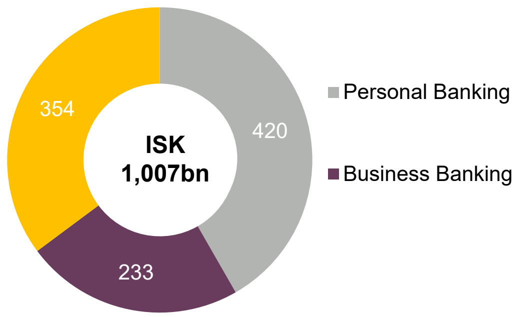
Loan portfolio

The table below sets forth the Bank's loan portfolio by maturity and sector, together with the split between fixed and floating interest rates for the loans with maturity over one year, as at 31 December 2020.

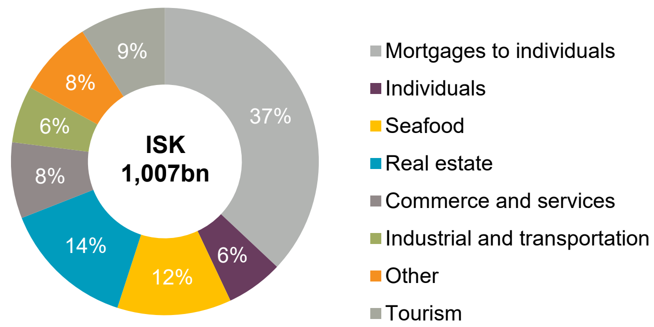
	As at 31 December 2020					
Loans and Commitments to Customers	**< 1 Year**	**1-5 Years**	**5-15 Years**	**>15 Years**	**Fixed**	**Floating**
	(ISK in millions)					
Individuals	16,539	25,021	31,222	364,595	229,488	191,350
Commerce and Services	23,310	49,420	18,929	32,601	6,695	94,255
Construction	23,670	5,826	3,073	9,783	261	18,420
Energy	51	3,775	2,183	2,664	1,554	7,069
Financial Services	1,107	6	-	426	6	426
Industrial and Transportation	12,478	20,151	36,179	9,753	1,604	64,478
Investment Companies	12,251	4,605	1,623	4,961	48	11,141
Public Sector and Non-Profit Organisations	1,321	4,248	3,291	2,051	165	9,426
Real Estate	17,401	68,100	9,306	62,695	30,159	109,942
Seafood	17,785	97,465	6,066	786	69	104,249
Total	**125,913**	**278,617**	**111,872**	**490,315**	**270,048**	**610,756**

The graphs below set forth the Bank's loan portfolio by division, sector, collateral type and currency type, as at 31 December 2020.

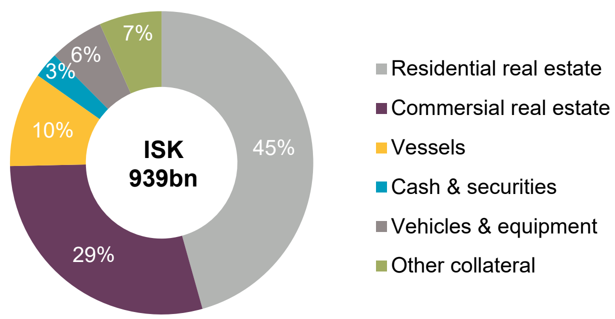
By business divisions



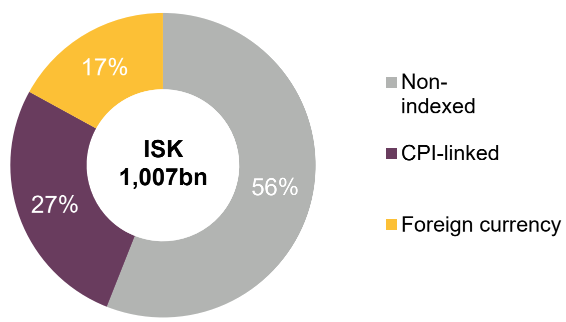
By sector



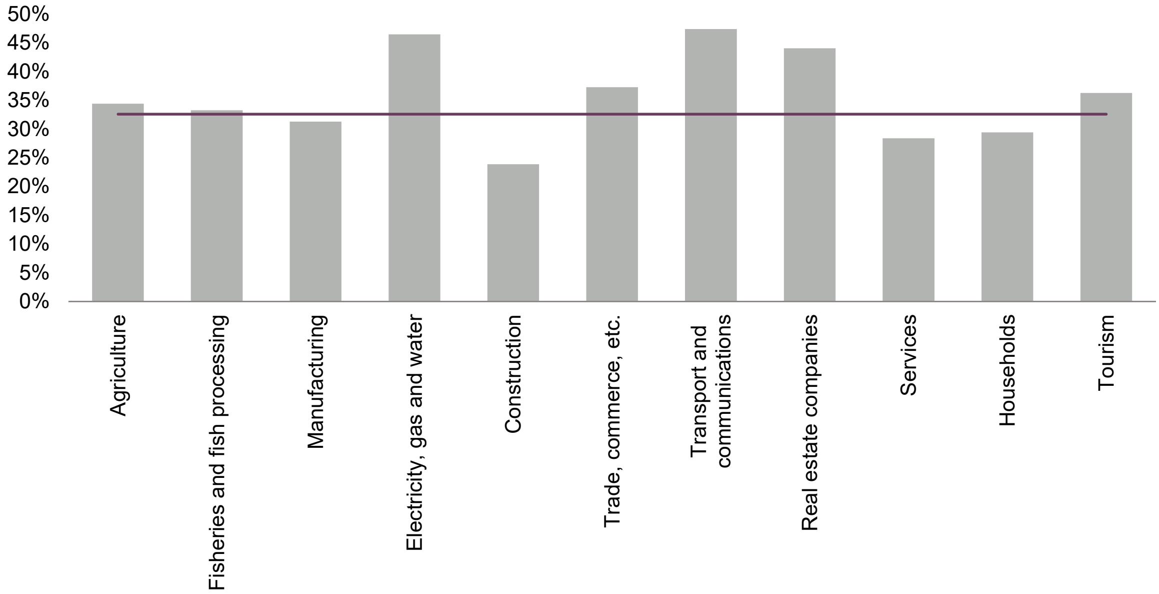
By collateral type



By currency type



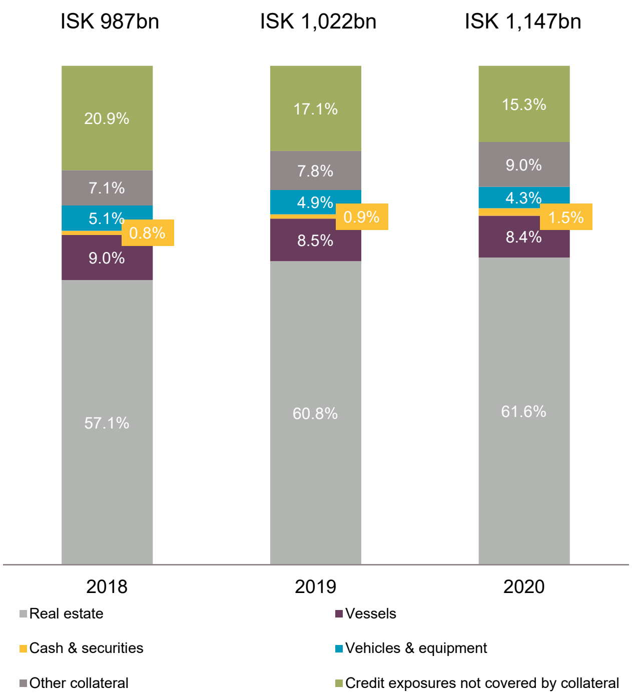
The Bank's exposure to sectors is largely aligned to the Bank's own estimates of its market shares in these sectors (with an average of 33%), as indicated in the graph below.



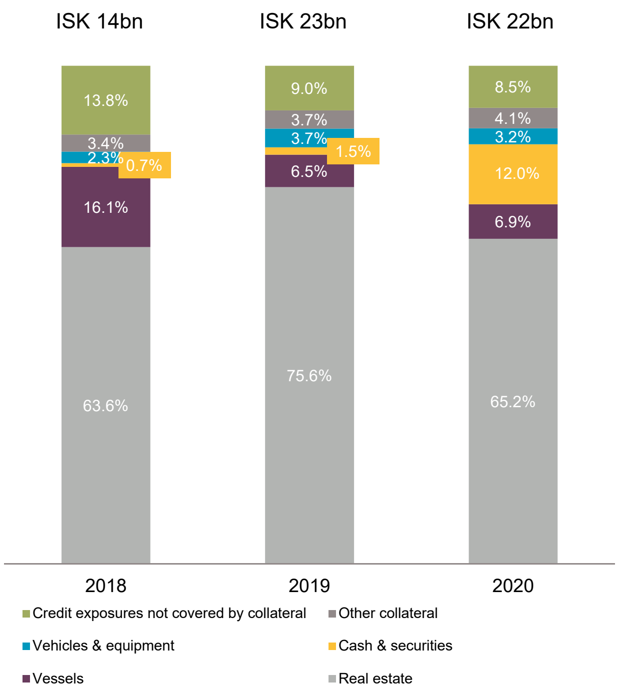
The Bank is constantly reviewing the loan portfolio and has recently been reviewing the part of the loan book currently classified as real estate companies, in order to better reflect the underlying risk class. As a result, some loans may be re-classified from real estate companies to other industries, should the Bank view the underlying risk better reflected, for instance where the underlying risk relates more to specific industry than the real estate market as a whole. Due to this, the segregation between industries is and will remain subject to certain changes.

The graphs below set forth the Bank's collateral held, by type of collateral, as at 31 December 2018, 2019 and 2020, organised against non-credit-impaired loans and credit-impaired loans.

Non credit-impaired, net carrying amount exposures Collateral held by type of collateral



Credit-impaired, net carrying amount exposures Collateral held by type of collateral



Allowance for Credit Losses

The tables below set forth impairment charges broken down by Stage 1, Stage 2 and Stage 3 categories, the corresponding total loan balance, the total write-off and the recoveries for each of the sectors, as at 31 December 2020, 2019 and 2018. The information is derived from the Annual Financial Statements and from unaudited accounting records of the Bank (in relation to the breakdown of recoveries).

	As at 31 December 2020						
Loans and Commitments to Customers	**Stage 1**	**Stage 2**	**Stage 3**	**Total impairments**	**Balance**	**Total Write-off**	**Recoveries**
				(ISK in millions)			
Individuals	(1,608)	(254)	(903)	(2,765)	437,377	393	(105)
Commerce and Services	(511)	(3,151)	(2,448)	(6,110)	124,260	326	(11)
Construction	(283)	(195)	(138)	(616)	42,352	22	(28)
Energy	(17)	(8)	0	(25)	8,673	0	0
Financial Services	0	0	0	0	1,539	0	0
Industrial and Transportation	(243)	(783)	(1,899)	(2,925)	78,561	115	(2)
Investment Companies	(268)	(427)	(284)	(979)	23,440	0	(8)
Public Sector and Non-Profit Organisations	(17)	0	0	(17)	10,911	0	0
Real Estate	(461)	(1,655)	(1,534)	(3,650)	157,502	435	(4)
Seafood	(237)	(9)	(181)	(427)	122,102	193	(1)
Total	**(3,645)**	**(6,482)**	**(7,387)**	**(17,514)**	**1,006,717**	**1,484**	**(159)**

	As at 31 December 2019						
Loans and Commitments to Customers	**Stage 1**	**Stage 2**	**Stage 3**	**Total impairment s**	**Balance**	**Total Write-off**	**Recoveries**
				(ISK in millions)			
Individuals	(1,319)	(168)	(1,148)	(2,635)	349,181	578	(152)
Commerce and Services	(739)	(194)	(1,772)	(2,705)	126,488	731	(6)
Construction	(310)	(53)	(238)	(601)	44,420	109	(19)
Energy	(26)	0	0	(26)	7,887	0	0
Financial Services	0	0	0	0	2,315	0	0
Industrial and Transportation	(278)	(221)	(1,546)	(2,045)	82,288	225	(1)
Investment Companies	(260)	(216)	(110)	(586)	23,590	73	(68)
Public Sector and Non-Profit Organisations	(23)	(2)	(1)	(26)	12,312	0	0
Real Estate	(542)	(89)	(590)	(1,221)	145,559	29	(2)
Seafood	(148)	(10)	(295)	(453)	105,592	86	(1)
Total	**(3,645)**	**(953)**	**(5,700)**	**(10,298)**	**899,632**	**1,831**	**(249)**

	As at 31 December 2018						
Loans and Commitments to Customers	**Stage 1**	**Stage 2**	**Stage 3**	**Total impairment s**	**Balance**	**Total Write-off**	**Recoveries**
				(ISK in millions)			
Individuals	(1,130)	(256)	(855)	(2,241)	319,390	1,332	(262)
Commerce and Services	(643)	(179)	(1,838)	(2,660)	124,242	2,353	(13)
Construction	(196)	(247)	(19)	(462)	29,095	22	(104)
Energy	(20)	(7)	0	(27)	6,858	0	0
Financial Services	(4)	0	0	(4)	1,704	0	0
Industrial and Transportation	(398)	(53)	(488)	(939)	79,824	927	(11)
Investment Companies	(217)	(103)	(116)	(436)	23,799	273	(14)
Public Sector and Non-Profit Organisations	(18)	0	(1)	(19)	12,087	0	0
Real Estate	(528)	(154)	(181)	(863)	142,885	108	0
Seafood	(123)	(80)	(191)	(394)	106,715	255	(12)
Total	**(3,277)**	**(1,079)**	**(3,689)**	**(8,045)**	**846,599**	**5,270**	**(416)**

Deposits

The tables below set forth deposit balances by time category, together with average rates paid, in each case broken down by customer type, as at 31 December 2020, 2019 and 2018.

As at 31 December 2020	On demand	<3 months	3-6 months	6-12 months	>12 months	ISK	Average rate paid ISK-CPI	Foreign exchange
				(ISK in millions)				
Deposits from CB and credit institutions	35,169	32,911	15,220	9,374	3,341	0.61%	0.00%	0.04%
Deposits from customers	488,390	52,458	36,695	5,463	40,192	0.15%	0.05%	0.00%
Retail	363,325	24,666	24,029	2,418	29,668	0.11%	0.05%	0.01%
Operational relationships	3,155	0	0	0	0	0.02%		0.00%
Corporations	75,306	17,681	8,785	2,007	850	0.27%	0.02%	0.02%
Sovereigns, Central Bank and public sector entities	7,507	720	193	3	25	0.16%	0.00%	0.00%
Pension funds	39,096	9,391	3,688	1,035	9,649	0.24%	0.17%	-0.02%
Domestic financial entities	30,387	30,174	12,229	7,141	0	0.74%	0.00%	-0.01%
Foreign financial entities	4,783	2,737	2,991	2,233	3,341	0.02%		0.26%
Covered by depositors' guarantee scheme	250,350	15,392	14,361	2,028	24,144			

As at 31 December 2019	On demand	<3 months	3-6 months	6-12 months	>12 months	ISK	Average rate paid ISK-CPI	Foreign exchange
				(ISK in millions)				
Deposits from CB and credit institutions	24,439	35,989	15,445	8,656	4,548	2.60%	0.00%	0.06%
Deposit from customers	425,760	62,916	25,788	12,067	33,630	1.02%	0.29%	0.08%
Retail	308,496	33,991	14,486	3,514	30,603	0.97%	0.24%	0.05%
Operational relationships	2,446	0	0	0	0	0.31%		0.03%
Corporations	72,358	23,325	2,258	52	672	1.35%	0.08%	0.23%
Sovereigns, Central Bank and public sector entities	7,054	512	93	0	27	1.44%	0.04%	0.02%
Pension funds	35,406	5,088	8,951	8,501	2,328	0.77%	0.99%	0.02%
Domestic financial entities	19,853	30,889	15,445	8,656	22	3.03%	0.00%	0.01%
Foreign financial entities	4,586	5,100	0	0	4,526	0.24%		0.32%
Covered by depositors' guarantee scheme	83,485	8,085	4,464	1,138	13,153			

As at 31 December 2018	On demand	<3 months	3-6 months	6-12 months	>12 months	ISK	Average rate paid ISK-CPI	Foreign exchange
				(ISK in millions)				
Deposits from CB and credit institutions	24,609	20,711	12,094	2,673	3,051	2.79%	0.00%	0.14%
Deposits from customers	399,616	62,025	23,315	3,840	42,644	1.75%	0.36%	0.12%
Retail	296,093	34,186	10,311	3,235	31,883	1.69%	0.31%	0.07%
Operational relationships	2,572	0	0	0	0	0.62%		0.10%
Corporations	62,406	20,810	3,386	173	262	2.12%	0.10%	0.32%
Sovereigns, Central Bank and public sector entities	7,860	502	50	5	33	2.65%	0.05%	0.04%
Pension funds	30,686	6,527	9,568	426	10,466	1.53%	1.16%	0.13%
Domestic financial entities	18,781	20,711	12,094	501	2	3.25%	0.00%	0.07%
Foreign financial entities	5,827	0	0	2,173	3,049	0.42%		0.50%
Covered by depositors' guarantee scheme	82,982	7,445	2,995	1,215	13,279			

RISK MANAGEMENT

Overview

Risk assessment and the prudent evaluation and pricing of risk are key elements in the Bank's operations. In turn, an efficient risk assessment framework forms the foundation of the Bank's risk and capital management strategy. The Bank's risk governance is based on a three lines of defence framework and aims for informed decision-making and strong risk awareness throughout the Bank.

Risk Governance and Organisation

The Bank is exposed to various risk factors and managing these risks is an integral part of the Bank's operations. The Bank emphasises sound governance principles. The risk management and internal control framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with the relevant laws, regulations, supervisory requirements and the Bank's internal rules and decisions.

Three Lines of Defence Model

The first line of defence consists of the Bank's business and support divisions. The business divisions take on risk through the extension of credit, through proprietary trading, and by providing other services to the Bank's customers. The primary responsibility for managing these risks lies with the business divisions. Each business division shall have in place effective processes to identify, measure or assess, monitor, mitigate and report on the risks taken on by the division. Support divisions, whose decisions have an impact on the Bank's operational risk and sustainability risk, are subject to the same requirements for risk identification and management as the Bank's business divisions.

The second line of defence comprises the Bank's internal control divisions. The internal control divisions are responsible for developing and maintaining an efficient internal framework to facilitate adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported or disclosed, and compliance with the relevant laws, regulations, supervisory requirements and the Bank's internal policies and procedures. The Bank's internal control divisions are Risk Management and Compliance.

The third line of defence provides independent assurance to management and the Board of Directors of the effectiveness and completeness of the internal control framework, including both the first and the second line of defence. The third line of defence duties are performed by Group Internal Audit.

The Bank's management body has a dual structure. The Board of Directors has a supervising role in setting and monitoring the execution of policies, the sound control of accounting and financial management and ensuring that group internal audit, compliance and risk management are effective. The Chief Executive Officer ("**CEO**"), the Chief Risk Officer ("**CRO**") and other members of the senior management committees are responsible for implementing risk management practises and internal control in accordance with Board authorisation.

The Bank's committee structure is divided into two categories, executive committees and business committees. There are two executive committees, the Executive Board and ARC. They are responsible for overseeing the implementation of the business strategy, risk appetite and policies. The business committees are five in total, the ALCO, the SCC, the IC, the OSC and SC. They are responsible for the approval of business proposals and the Bank's operational framework and implementation subject to internal rules and guidelines issued by the executive committees and the Board. The members of all the senior management committees are appointed by the CEO, and each committee's mandate and rules of procedure is documented in a charter

The ARC is responsible for reviewing and overseeing the implementation of risk management and internal control policies issued by the Board. ARC translates the Board-approved risk policies into risk limits or guidelines for individual business divisions, desks or portfolios and approves methods and assumptions used for calculating risk measures, capital and liquidity requirements and targets, impairment, and internal and external pricing. The committee reviews and confirms proposals regarding risk assessment, impairments and capital and liquidity requirements prior to submission to the Board of Directors for approval. The CRO chairs the ARC.

The Board defines the Bank's risk appetite, tolerance, and financial targets in the Risk Appetite Statement. The Risk Appetite Statement is intended to support the Bank's business strategy by defining high-level limits and targets for core factors in the Bank's risk profile and operations.

The measures include target return on equity, target capitalisation level and capital composition, maximum credit losses, concentration limits, maximum amounts at risk for market risk and target liquidity ratios.

The Risk Appetite Statement is further implemented through risk policies, approved by the Board, and other rules, procedures and limits approved by the ARC which provide more details specific to each risk type. In addition, the Risk Assessment Framework and the Stress Testing Framework, approved by the Board, describe the processes for identifying and assessing the risks inherent in the Bank's operations.

The table below presents key metrics from the Risk Appetite Statement as compared to actual results for 2020.

	Metrics	Limit	2020 Outcome
Profitability	Return on equity	8-10% by 2023 >10% long-term	3.7%
	Cost-to-income ratio	<45%	54.3%
	Target dividend ratio	c. 50% of profits	50%
Capital adequacy	CET1 capital ratio	16%	20.1%
	Total capital target	17.5-19.0%	23.0%
Credit risk	Long-term annual credit losses (excluding mortgages)	<0.9%	0.57%
	Non-primary lending activity	<ISK 22 billion	ISK 17.3 billion
	Concentration risk (20 largest groups as a percentage of total capital)	<160%	122%
Market risk	Market risk (percentage of total capital)	<15%	6.5%
Liquidity risk	Liquidity coverage ratio	>120%	196%
	Net stable funding ratio	>110%	123%
	Encumbrance ratio	<25%	18.7%
Operational risk	Quarterly operational losses (percentage of Pillar 1 capital for operational risk)	<3%	

Risk Monitoring and Reporting

Risk Management provides a holistic view on risk and compliance to limits, to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches. Business and support divisions are, however, responsible for maintaining their independent view on the risks inherent in their operations, implementation of controls and other mitigating actions where needed, and reporting to senior management any present or foreseeable breaches from limits, policies or strategic direction.

Risk Management is responsible for providing the ARC, the Board's Risk Management Committee and the Board with comprehensive and understandable information on the overall risk profile of the Group, including a comparison with the approved policies and limits. The table below provides an overview of risk reporting and frequency to the ARC and the Board of Directors.

Internal Reporting	Details	Frequency
Risk Dashboard	The report provides a review of risk measures that summarise the main risk positions as compared to the risk appetite, internal tolerance and regulatory limits. This includes utilisation of limits set by the Board or Executive and Business Committees. The report also includes the status of the Bank's contingency indicators. On a quarterly basis the report includes an assessment of capital adequacy in light of changes in risk profile (ICAAP review).	Monthly
Compliance report	The report provides an overview of the main supervisory tasks of the compliance division, identified deficiencies and reactions.	Semi annual
ICAAP report	The ICAAP report includes a detailed description of how the Bank identifies, measures and assesses its capital adequacy in	Annual

Internal Reporting	Details	Frequency
	relation to its risk profile and business model. The scope of the assessment encompasses all material risks to which the Bank and its subsidiaries are exposed.	
ILAAP report (Internal Liquidity Adequacy Assessment Process)........	The ILAAP report includes a detailed description of how the Bank identifies, measures and assesses its liquidity adequacy in relation to its risk profile. The report also includes a forward-looking analysis based on contractual inflows and outflows, planned issuance and new lending according to the Bank's business plan.	Annual
Recovery Plan	The document provides a comprehensive recovery plan for the Bank that sets out measures to be taken for the recovery of the Banks's financial position following a significant deterioration to restore financial stability.	Annual

Risk Taxonomy

The Bank maintains a risk taxonomy that identifies all material and key risks. Although credit risk accounts for most of the Bank's risk exposure amount, all material risks are measured and monitored in line with the process below.

External Causal Factors		Internal Causal Factors	
• Political	• Technological	• People	• Products
• (Macro) economic	• Environmental	• Processes	• Clients
• Social	• Legal	• Systems	• Reputation
		• Balance sheet	

↓

Enterprise Risk

Credit Risk	Concentration Risk	Market Risk	Liquidity Risk	Operational Risk	Sustainability Risk
• Default risk	• Name concentration	• Interest rate risk	• Funding risk	• ICT risk	• Physical climate risk
• Specialised lending	• Sector concentration	• Equity risk	• Deposit concentration	• Conduct risk	• Social risk
• Indirect credit risk	• Product concentration	• Foreign exchange risk		• Compliance risk	• Governance risk
• Foreign exchange lending risk	• Collateral and guarantees concentration	• CPI risk		• Business and strategic risk	• Transitional climate risk
• Settlement risk	• Geographical concentration	• Spread risk		• Process risk	
• Valuation risk		• Commodity risk		• Legal risk	
• Country risk				• Outsourcing risk	
• Credit risk from securitisations				• Model risk	

Credit Risk

Credit risk is defined as the 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.

Credit concentration risk is the increase in risk that is driven by common underlying factors, such as 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 probability of default is driven by common underlying factors.

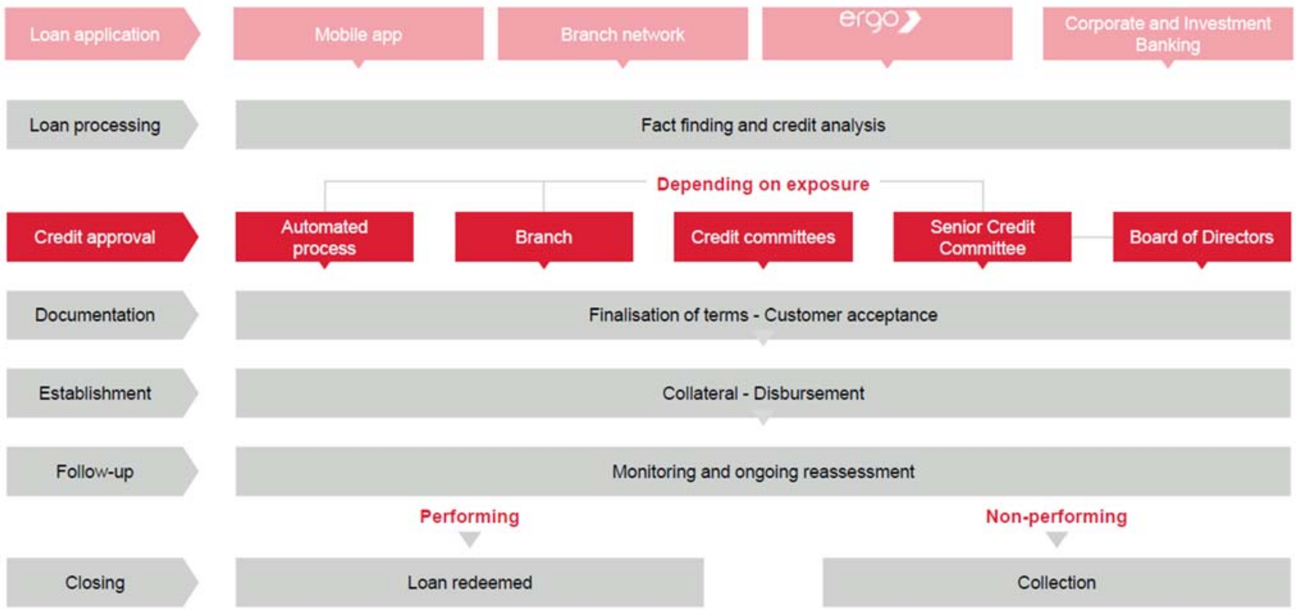
The ultimate responsibility for ensuring an adequate credit risk management and internal control framework at the Bank lies with the Board of Directors. The Board defines the credit risk governance framework and the acceptable level of credit risk through the Risk Management and Internal Control Policy, the Risk Appetite Statement, and the Credit Risk Policy.

The Bank's strategy is to maintain a modest credit risk profile and it aims to have long-term average annual credit losses less than 0.9% of the loan portfolio, excluding the liquidity portfolio and the qualified retail mortgage portfolio. This risk appetite is reflected in the credit risk limit structure and guided through the use of credit risk assessment models.

Credit risk activities are controlled through exposure limits applied to counterparties, countries, sectors, and products.

The Bank's credit process is based on a committee structure where the SCC has the authority to approve credit proposals within authorisation limits set by the Board of Directors. The SCC then appoints and allocates credit authorisation limits to its subcommittees and to individual employees such as branch managers and credit managers. Credit authorisation limits can have reference to the risk class of the counterparty or to specific credit products. For certain retail products, such as mortgages, overdrafts and credit cards to individuals, credit decisions are in part based on an automated approval process.

The diagram below outlines the credit approval process, with clear lines of delegation of authority for credit decisions.



The Bank's Credit Rules outline the principles governing loans, guarantees, and other products that expose the Bank to credit risk. Trust between the Bank and its customers is a prerequisite for all lending, as well as the customer's ability and willingness to repay in a timely manner. Sufficient collateral alone cannot justify lending to customers with insufficient payment capacity. According to the Bank's Sustainability Policy it is required that sustainability and ESG risk is evaluated in the credit granting and risk assessment process.

To mitigate risk, the Bank requires collateral that is appropriate for the product offered. For some products, such as relatively small overdrafts to individuals, no collateral is required, given that the customer's creditworthiness meets the Bank's criteria. Since the Bank does not seize collateral unless a borrower faces serious repayment difficulties, the valuation of collateral focuses on its future expected value at the time of default. The Bank has appointed a Collateral Council that reviews and proposes guidelines for the valuation of collateral and pledged assets. The objective is to ensure that the valuation of collateral is coordinated throughout the Bank.

As the first line of defence, the business divisions continuously monitor their loan portfolio and periodically re-assess customers' performance, based on both internal and external data. Collection procedures are set to be agile and swift to keep arrears at minimum. Loan covenants are monitored, and appropriate actions are taken to protect the Bank's interests if there are covenant breaches.

In 2020, the Bank entered into an agreement with other lenders in Iceland to provide a uniformly executed moratorium for corporate and household customers that faced a temporary reduction in income due to COVID-19. In accordance with guidelines from EBA and the Central Bank of Iceland, moratoria of this kind do not trigger classification as forbearance. However, any concessions due to financial difficulties granted after the expiration of the general moratoria offered under the agreement are classified as forbearance.

Measurement and Monitoring

Portfolio credit risk is measured both in terms of current events and possible future events. Current events include non-performing ratios, the scope of forbearance agreements and impairment allowance for defaulted facilities, while possible future events are captured by measurements such as the probability of default and the impairment allowance for non-defaulted facilities

To ensure that the Bank charges an adequate interest rate and that it has sufficient capital reserves to ensure long-term sustainability, the Bank estimates expected and unexpected losses of its loan portfolio.

The long-term expected credit loss on the loan portfolio is covered by a part of the interest rate margin. Due to various underlying factors, the observed annual losses can fluctuate significantly around the long-term average, sometimes up to an order of magnitude. To be able to cover these unexpected losses at any time, the Bank holds a substantial capital buffer against these fluctuations. An adequate return on this capital buffer also needs to be covered by the interest rate margin.

Credit Concentration

The Bank monitors credit concentration risk which arises from the unequal and granular distribution of exposure to borrowers, industry sectors, and geographic regions. The portfolio concentration is monitored and constrained by limits set in the Risk Appetite Statement.

Borrower Concentration

The Bank actively seeks to limit large exposures. A large exposure is defined as an exposure to a group of connected clients that is 10% or more of the Bank's total capital base. The exposure is evaluated both before and after application of eligible credit risk mitigating effects according to relevant rules. When assessing the exposure, both on-balance sheet items and off-balance sheet items from all types of financial instruments are included. The Bank has internal criteria that define connections between clients in line with Icelandic law and EBA guidelines, where groups of connected clients are defined.

At year-end 2020, the Bank had one large exposure which after eligible credit risk mitigating effects amounted to 10% of capital base. This is an increase from 2019 when the Bank had no large exposure.

The Bank seeks to limit borrower concentration risk and has an internal limit on the aggregated exposures to the 20 largest groups of connected clients.

Industry Sector Concentration

The Bank has limits on both the exposure to any single economic industry sector as well as the aggregated exposure to the three largest economic industry sectors as a percentage of the Bank's total credit exposure. Exposure to individuals, as an economic industry sector, is also considered separately.

The tourism industry is an important economic sector in Iceland but due to the nature of tourism, its effects are not limited to hotels, car rentals and tour guides. The Bank therefore monitors the tourism industry internally as a quasi-sector instead of a separate sector.

Geographic Concentration

Specific geographical limits are established to manage country risk. The geographical limits apply to the country from where the credit risk arises. Iceland is considered to be a home market and is as such not subject to geographical limits.

Most of the Bank's activities are in Iceland but the Bank maintains a certain amount of international activities. The overseas strategy is built on a heritage of servicing the core industries in Iceland, primarily focusing on the seafood industry. The strategy focuses on the North Atlantic region, including Canada, the United States, and Norway.

Product Concentration and Collateral Concentration

The Bank regularly monitors product concentration and collateral concentration but neither type is currently considered to be material.

Settlement Risk

To mitigate settlement risk on counterparties, the Bank utilises the services of clearing houses and applies the general rule of delivery versus payment. If such a rule is not applicable due to the nature of the business relationship, a settlement limit is assigned to the counterparty to limit the risk.

Counterparty Credit Risk

Counterparty credit risk ("**CCR**") is the risk arising from the possibility that the counterparty may default on amounts owed on a derivative transaction.

The Bank takes on CCR when entering into derivatives transactions. This includes, but is not limited to, interest rate swaps and futures, cross-currency swaps, equity forwards, and options.

The Bank actively uses derivatives to hedge currency, interest, and inflation exposures. Such derivatives contracts are generally subject to ISDA master agreements with a Credit Support Annex, or similar terms, with collateral in the form of cash and eligible bonds. Counterparties in these contracts are also subject to approved credit limits.

When setting credit limits for counterparties in derivatives contracts, the Bank follows the same process as for other credit exposure and, as for credit concentration risk in general, credit limits for counterparties are constrained by various concentration limits, many of which are defined in terms of the Bank's capital base.

Credit Risk Exposures

Credit risk exposure comprises both on-balance sheet and off-balance sheet items. Exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the Annual Financial Statements. The exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less the impairment the Bank has made for these items. The credit exposure for capital requirement purposes does not reconcile with the net carrying amount in the Annual Financial Statements mostly due to the contribution of off-balance sheet items. For capital requirement purposes, credit conversion factors are applied to guarantees and undrawn commitments. For derivative contracts, the exposure is calculated by adding potential future credit exposure to the positive market value of the contract. The Bank currently has no direct credit exposure to securitisation.

The table below sets forth the Bank's main sources for credit risk at year-end 2020 and 2019 (ISK billion) on a consolidated basis.

Credit risk	**31.12.2020**	**31.12.2019**
Loans to customers	1,006.7	899.6
Balances with the Central Bank and loans to credit institutions	168.9	201.0
Bonds and debt instruments	128.2	52.9
Off-balance sheet items	152.4	135.8
Derivatives	9.9	9.5
Other financial assets	3.7	5.8
Maximum credit exposure	**1,469.8**	**1,304.6**

The Bank's exposure deriving from off-balance sheet items totalled ISK 152 billion at year-end 2020 compared to ISK 136 billion the year before. For regulatory purposes a credit conversion factor is applied to calculate the exposure under the credit risk framework. Calculated in this way, the regulatory credit exposure deriving from off-balance sheet items totalled ISK 48 billion at year-end 2020 compared to ISK 39 billion at year-end 2019.

The Bank uses derivatives to hedge currency, interest, and inflation exposure. The Bank carries relatively low exposure due to margin trading with clients and in these cases, the Bank holds collateral to cover possible losses. Credit risk for derivatives amounted to ISK 9.9 billion at year-end 2020 compared to ISK 9.5 billion the year before.

Country Risk Exposure

Exposure to countries other than Iceland amounted to ISK 136 billion at year-end 2020. This exposure relates mainly to the management of the Bank's foreign liquidity reserves. The Bank has no retail lending activities outside of Iceland but maintains a modestly sized portfolio of lending to companies in the United States, Canada, and Norway within its North-Atlantic strategy. The exposure to companies within this portfolio was ISK 28 billion at year-end 2020.

Loans to Customers

Loans to customers, both individuals and companies, represent the largest part of the Bank's credit risk exposure. This section describes the portfolio of loans to customers and its development.

At year-end 2020 the net carrying amount of the portfolio of loans to customers was ISK 1,007 billion, having grown from ISK 900 billion at year-end 2019. This growth of 11.9% is mainly due to the increase in the mortgage portfolio which grew by ISK 96 billion on the back of ISK 206 billion in lending, a part of which was refinancing of outstanding mortgages due to more favourable interest rates.

As a principle, the Bank aims to have the currency composition of loans to customers in balance with customer needs. In particular, loans to customers whose income is predominantly in ISK should be denominated in ISK. The Bank has in place rules regarding lending in foreign currency, ensuring management of this risk. Loans to customers are categorised into three currency types, non-indexed ISK, CPI linked ISK, and Foreign currency (foreign exchange).

Loans Covered by Collateral

Collateral and other credit risk mitigants vary between types of obligors and credit facilities. Loans to eligible credit institutions are usually unsecured. For loans to individuals, the principal collateral pledged is residential property against mortgages. Unsecured loans to individuals are mostly short-term consumer loans such as overdrafts and credit cards. In the case of large companies, pledged collateral includes real estate, fishing vessels, cash and securities, as well as other collaterals such as accounts receivable, inventory, vehicles, and equipment. Loans to government entities and municipalities are generally unsecured. The measured credit risk exposure of loans is not affected by the pledged collateral.

In some cases, the Bank uses guarantees as credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in exposure to credit risk although they may strengthen its quality. The guarantees which the Bank accepts are from parties which have some association with the obligor, e.g. direct ownership. Thus, the Bank does not use general credit derivatives to mitigate credit risk. Covenants in loan agreements are also an important credit enhancement though they do not reduce credit exposure.

In 2020, the Bank temporarily offered support loans and supplementary facilities with full or partial government guarantee as part of governmental and economic actions to counteract the impact of COVID-19. These Treasury guarantees are, from credit quality standpoint, treated as collateral unlike other third-party guarantees.

Valuation of collateral is based on market price, official valuation from Registers Iceland, or the expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels, the assigned fishing quota is included in the valuation, based on a valuation by the Bank's Collateral Council. Valuations can only be valid for a certain amount of time and must therefore be reassessed regularly. Since the price volatility differs between asset classes it is interesting to consider how the LTV distribution of the portfolio is split between these classes.

To assess the financial effect of collateral on maximum credit exposure, the Bank allocates collateral to loans using an optimisation algorithm. Among other things, the algorithm ensures that collateral is not assigned in excess of its estimated value, in excess of any maximum amount stipulated in a collateral agreement, in excess of the claim value of the relevant loans, or the maximum potential exposure in case of facilities with an undrawn component. The last constraint means that if some loans have collateral values in excess of their claim value, then the excess is removed in this assessment in order to reflect the Bank's actual exposure to credit risk.

Risk Profile

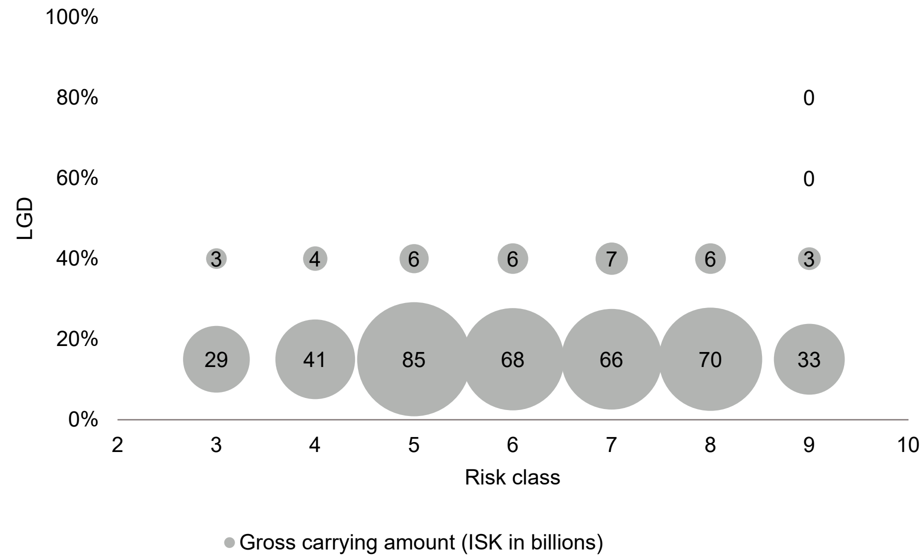
Each obligor is assigned a risk class depending on how likely they are considered to default in the next 12 months. Note 50 to the Annual Financial Statements shows the breakdown of loans to customers, off-balance sheet loan commitments, and financial guarantees into risk class groups and stages.

According to IFRS 9, the impairment allowance, i.e. the difference between the gross and the net carrying amount, is the expected credit loss (ECL). The table below shows the breakdown of the ECL for loans to customers by IFRS 9 stages. The columns show the contribution to the ECL from the probability of default (PD) and the loss given default (LGD). For facilities in Stage 3, the PD does not apply since default has already occurred. Additionally, the LGD contribution is divided into the probability that the default will not cure, and thus lead to an economical loss (loss rate), and the expected size of the eventual economic loss (loss severity). Finally, for facilities in Stage 2, the loss allowance is equal to the expected loss for any events occurring during the lifetime of the facility, the contribution of this is shown in the column Effect of lifetime loss below.

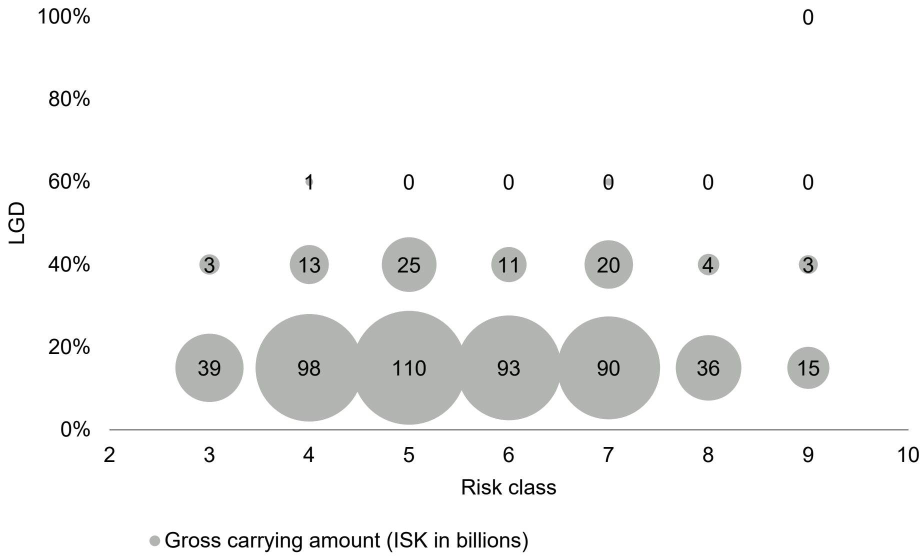
Stage	**Gross carrying amount**	**PD**	**LGD loss rate**	**LGD loss severity**	**Effect of lifetime loss**	**ECL**
	(ISK billion)	(%)	(%)	(%)	(%)	(%)
Stage 1	835.4	5	38	21	100	0.4
Stage 2	159.5	13	63	17	266	4.1
Stage 3	29.2	100	68	38	100	25.3

The graphs below set forth the LGD and risk class distributions of the Bank's loan portfolio as at 31 December 2020. The graphs show the accumulated exposure per each risk class and LGD bucket where the LGD range is split among 5 equal intervals of 20%. The area of each bubble scales with the exposure, i.e. larger bubbles represent larger exposures. The graphs show a general picture of the distribution of the respective loan portfolios with regards to risk, where sums closer to the upper right corner are riskier than those in the lower left one. Corporates and SMEs are shown together although the risk class to PD mapping is slightly different between the two. The graphs are for illustration purposes.

Individuals and households



Corporates and SMEs, ISK in billions



The Bank monitors the non-performing loans (NPL) ratio but due to the adoption of IFRS 9 it has been necessary to change the definition. The non-performing ratio that the Bank uses, is based on the gross carrying amount of loans to customers that are in default (i.e. Stage 3). When doing comparisons on NPL ratios between different banks it must be borne in mind that an industry standard has not yet emerged on how to define the NPL. The NPL ratio will usually not be comparable between banks unless they use the exact same definition. The Bank's NPL ratio was 2.9% at year-end 2020 compared with 3.0% at year-end 2019.

Market Risk

Market risk is defined 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, inflation, equity prices and foreign exchange rates.

Market risk has been identified as one of the key risk factors in the Bank's operations. The Bank takes on market risk as a part of its business strategy and aims to maintain a moderate market risk profile. The objective of the Bank's market risk management framework is to manage and control market risk exposures and ensure that the market risk profile is within the Board's approved risk appetite.

Market risk at the Bank is split into two categories, trading book and banking book. Market risk due to mismatches in assets and liabilities with respect to currencies, interest reset dates and CPI-indexation falls in the banking book. Market risk in the banking book also includes exposures held for long-term investment purposes, in unlisted securities and holdings in subsidiaries or affiliates. Market risk exposures in the trading book are related to short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. The positions are undertaken mainly as a part of the Bank's flow trading, through the Bank's liquidity portfolio and as hedges against customers' derivatives contracts.

The ultimate responsibility for ensuring an adequate market risk management and internal control framework at the Bank lies with the Board of Directors. The Board defines the market risk governance framework and the acceptable level of market risk through the Risk Management and Internal Control Policy, the Risk Appetite Statement and the Market Risk Policy.

The ARC is responsible for the review and implementation of the Market Risk Policy and the market risk appetite. The ALCO decides on individual proposals for assuming and pricing market risk on behalf of the Bank within the appetite and limits approved by the Board and ARC. The managing director of Corporate & Investment Banking and the CFO are responsible for the market risk taken on or owned by their divisions and for earning an acceptable level of return on these risks. The directors of business divisions that take on market risk on behalf of the Bank are responsible for identifying and managing the risk in their portfolios within limits approved by the Board, ARC or ALCO.

The Bank uses various tools to measure, monitor and limit market risk exposures. These tools include conventional risk measures, limits on notional and sensitivity measures. The Bank's overall market risk exposure is measured according to the Bank's Market Risk Measurement Framework (MRMF) and the Risk Appetite Statement mandates that the Bank's market risk shall not exceed 15% of the Bank's capital base. The MRMF uses stress tests to calculate potential losses from extreme but plausible market events for each risk exposure, both for the current position of each portfolio, as well as the maximum position within the limits for the given portfolio. Limits are also set to manage the concentration risk towards single issuers or instruments, as well as to manage trading liquidity risk. The Bank is also exposed indirectly to market risk through customers' derivative positions. Those positions are subject to strict margin and monitoring requirements.

The business divisions, as the first line of defence, are responsible for continuous monitoring of the market risk inherent in their operations, for maintaining their view on these risks and for notifying senior management of any foreseeable breaches of limits, policies or strategic direction. Risk Management, as the second line of defence, monitors the overall market risk profile of the Group, ensures proper escalation of limit breaches and provides an independent view on all market risk taken on by the Group.

Equity Risk

The Group's equity risk arises from flow trading, market making, shares acquired through restructuring of companies, and strategic investments.

The equity risk is managed through limits on aggregate market value and maximum exposure or market share in single securities. Equity risk includes bonds with equity-like features but excludes hedges against customers' equity forward positions. Equity exposure in the trading book decreased in 2020 with an average position of ISK 1.3 billion compared to ISK 1.7 billion in 2019. The maximum equity exposure in the trading book was ISK 2.3 billion in 2020 compared to ISK 3.0 billion in 2019. Equity exposure in the banking book, including fair value shares and shares held for sale, also declined from ISK 8.7 billion at the end of 2019 to ISK 5.8 billion at the end of 2020. The Group had no equity underwriting positions at the end of the year 2020 but had an ISK 3.0 billion underwriting position in September 2020.

An overview of the equity instruments is presented in Note 19 to the Annual Financial Statements. Please note that bonds with equity-like features are excluded in Note 19 which is not in line with equity risk as it is defined by the Bank from a risk management perspective. For information on equity forward positions, see Note 25 to the Annual Financial Statements.

Interest Rate Risk

In 2020, the Central Bank of Iceland cut its key interest rate four times, taking the rate from 3.0% to 0.75% as a response to COVID-19 and recently increased to 1.0% in May 2021. The Central Bank of Iceland's Monetary Policy Committee also decided to stop offering one-month term deposits with the aim to increase liquidity in circulation and further strengthen monetary policy transmission. This change caused the Bank to move a large share of its liquidity portfolio in ISK out of Central Bank of Iceland deposits to interest rate sensitive bonds.

To manage interest rate risk, the Bank uses sensitivity measures like basis point value (BPV). The BPV measures the effect of a 0.01 percentage point (1 basis point) parallel upward shift in the yield curve on the fair value of the underlying position. The Group's total interest rate risk increased in 2020 as interest rate risk in the trading book increased and interest rate risk in the banking book changed from being net long duration on the liability side to being net long duration on the asset side.

The Group's interest rate exposures in the trading book arise mainly from flow trading, market making and liquidity management. All positions in the trading book are subject to BPV or duration limits, both intraday and end-of-day limits. In addition to BPV limits, there are limits on the total short and long positions in underlying bonds. For foreign bonds and bills in the liquidity portfolio there are issuer rating and maturity limits. Interest rate risk in the trading book rose as the Bank moved a larger share of its liquidity portfolio in ISK out of Central Bank of Iceland deposits to interest rate sensitive bonds. This was mainly triggered by the Central Bank of Iceland lowering its key interest rate and by the Central Bank of Iceland's decision to stop offering one-month term deposits. The maximum interest rate risk, measured as the absolute value of the effect of a 100 basis points parallel adverse shift in yield curves, was ISK 759 million in 2020 compared to ISK 263 million in 2019. An overview of the Bank's interest rate risk in the trading book is provided in Note 60 to the Annual Financial Statements.

Interest rate risk in the banking book (IRRBB) arises from the Group's core banking activities. It represents the risk of loss from fluctuations in future cash flows or fair value of financial instruments as market rates change over time, reflecting the fact that the Group's assets and liabilities are of different maturities and are priced relative to different interest rates. The Group's main sources of interest rate risk in the banking book are fixed rate mortgage loans, covered bond debts and fixed-term deposits.

Interest rate risk in the banking book is managed by limits on the sensitivity of the fair value of the Bank's assets and liabilities to changes in market rates. All interest-bearing assets and liabilities are bucketed according to their next interest rate reset date, and the effect of a 100 basis points upward parallel shift on the interest rate exposure is measured. The sensitivity calculations are based on the duration of the underlying assets and liabilities. The calculations exclude non-performing loans since the valuation of such loans is based on the expected recovery and is not affected by changes in the underlying interest rates. An overview of the Bank's interest rate risk in the banking book is provided in Note 60 to the Annual Financial Statements.

In addition to a parallel shift in yield curves, the Group measures the effect of a so-called weighted adverse shift in yield curves. This entails that different weights are used to shift each yield curve in a direction that results in a loss for the Group, and the effect per yield curve is then added up to a single amount.

Inflation Risk

The Group is exposed to inflation risk since assets linked to the CPI exceed liabilities linked to the CPI. The net carrying amount of all CPI-linked assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI affect the Group's profit and loss through interest income. The inflation risk inherent in the trading book positions is captured through the interest rate risk of the positions.

In 2020, the Bank adjusted its policy regarding inflation imbalance so that it now aims to maintain an inflation imbalance that minimises the effect of unanticipated changes in the CPI on the Bank's capital ratio and considers such a position as neutral. The Bank still allows the imbalance to vary around the neutral position, but the adjusted policy means the Bank tends to maintain a positive inflation imbalance rather than keeping the size of CPI-linked assets and liabilities matched. The inflation imbalance rose in the first half of 2020 but fell again in the second half of the year, amounting to ISK 26.2 billion at year-end 2020 compared to ISK 20.7 billion at year-end 2019.

Currency Risk

Currency risk arises when financial instruments are not denominated in the Group's reporting currency, especially if there is a mismatch in the currency denomination of assets and liabilities.

Currency risk is managed within regulatory and internal limits, with separate limits for the banking book and the trading book. The overall consolidated currency imbalance was ISK 5.1 billion at year-end 2020 compared to negative ISK 0.1 billion at year-end 2019.

Derivatives

The Bank offers various types of derivative products to its customers and uses derivatives to hedge risks on its own balance sheet. The main products offered to customers are interest rate swaps (IRS), cross-currency interest rate swaps (CIRS), foreign exchange swaps, outright forwards (foreign exchange forwards) as well as equity and bond forwards. The Bank uses derivatives to hedge imbalances with respect to currency exposure, interest rate risk and inflation risk in the banking book. Other derivatives in the Group are insignificant.

All derivatives positions that carry direct market risk are subject to risk limits. The overall position in interest rate swaps and cross currency interest rate swaps is subject to both BPV and duration limits, while options are subject to several limits, including a limit on the open delta position in each underlying instrument. Derivatives positions that are fully hedged do not carry direct market risk but are exposed to indirect market risk due to counterparty credit risk. These positions include customers' forward contracts on equities, bonds and foreign exchange. Such positions are subject to notional limits that cap the Bank's indirect exposure to the underlying risk factors. For further information on derivative contracts see Note 25 to the Annual Financial Statements.

Liquidity and Funding Risk

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

Sound and efficient management of liquidity risk is a key factor to ensure the viability of the Bank's operations and to achieve and maintain a target credit rating. The Bank takes a conservative and prudent approach to managing liquidity risk and its liquidity strategy assumes that the Bank always fulfils regulatory requirements, internal thresholds and can sustain a prolonged period of stress. Following are the key principles on which the Bank's liquidity risk management framework is based:

- clear responsibilities and ownership of liquidity risk and liquidity risk control;
- the definition, categorisation and management of liquid assets shall be clear;
- the Bank maintains a portfolio of liquid assets to be able to service its liabilities even if access to funding markets is impaired; and
- the Bank has in place a Liquidity and Capital Contingency Plan which is tested regularly.

The Bank's liquidity risk appetite is reflected in the liquidity risk framework and guided through the liquidity limit structure.

The ultimate responsibility for ensuring an adequate liquidity risk management and internal control framework at the Bank lies with the Board of Directors. The Board of Directors defines the liquidity risk governance framework and the acceptable level of liquidity risk through the Risk Management and Internal Control Policy, the Risk Appetite Statement and the Liquidity Risk Policy.

The ARC is responsible for the review and implementation of the Liquidity Risk Policy, Liquidity and Capital Contingency Plan and the liquidity risk appetite. The ALCO decides on individual proposals for internal and external pricing, subject to the policies and models approved by the Board and the ARC. The ALCO also reviews and approves investment policies for managing the Bank's liquid assets, reviews and approves the contingency stage assessment as part of the Bank's Liquidity and Capital Contingency Plan and reviews information about the liquidity position of the Bank with respect to targets and limits.

The CFO, as the managing director for Treasury, is responsible for ensuring the necessary resources and training of employees for understanding, identifying, measuring or assessing, monitoring, mitigating and reporting on funding and liquidity risk. Treasury is responsible for the liquidity management of the Bank, in line with the internal and regulatory limits and policies, and the associated risks. Treasury is also responsible for the Bank's funding operations and the internal pricing framework.

The Bank complies with guidelines on liquidity management which are based on the Principles for Sound Liquidity Risk Management and Supervision, issued by the Basel Committee on Banking Supervision.

Measurement and Monitoring

Key measures for the assessment of liquidity risk are the LCR and NSFR ratios introduced by the Basel Committee on Banking Supervision in 2010 and incorporated into European law through the CRD IV.

The Central Bank of Iceland, which is the supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the Rules on Liquidity Ratio and the Rules on Funding Ratio in Foreign Currencies. At the end of 2019, the Central Bank of Iceland announced amendments to the LCR Rules that implement a 50% minimum liquidity coverage ratio in Icelandic Króna. The requirement is introduced in stages, beginning at 30% through 2020 and 2021, increasing to 40% in 2022 and finally reaching the full 50% at the beginning of 2023. As of 2020, the new minimum requirements did not pose any challenge for the Bank as the ISK LCR had been well above 50% throughout 2020.

The Recovery and Resolution Act on the resolution of credit institutions and investment firms amended the amount guaranteed in the deposit guarantee scheme. Payments to each depositor are now guaranteed up to the equivalent of EUR 100,000 in ISK. This regulatory change increases the amount of stable deposits reported for LCR and NSFR.

The minimum standard for the NSFR has been implemented in foreign currencies and the Central Bank of Iceland has issued a plan regarding implementing the standard in Iceland for all currencies that will take effect in 2021. In addition, the Central Bank of Iceland receives additional liquidity monitoring metrics (AMM) to obtain a comprehensive view of the Bank's liquidity risk profile. The AMM cover a wide array of monitoring metrics, including a maturity ladder, funding concentration, concentration of counter-balancing capacity and rollover of funding.

According to the Central Bank of Iceland's rules on liquidity ratios, the Bank submits monthly reports on the LCR and NSFR ratios along with AMM reports to the Central Bank of Iceland. As COVID-19 started in spring 2020, the Central Bank of Iceland increased the reporting frequency to weekly in order to better monitor the liquidity status. In addition to these regulatory measures, the Bank monitors several quantitative and qualitative liquidity measures, both static and forward-looking, to assess and quantify its liquidity position and thereby its liquidity risk. These include predefined triggers for the assessment of liquidity stage and forecasts of the development of the LCR. The assumptions for the internal liquidity measures are reviewed regularly.

Treasury, as a first line of defence, is responsible for continuous monitoring of the liquidity risk inherent in the Bank's operations and for notifying senior management of any foreseeable breaches from either internal thresholds, regulatory limits or strategic direction. Risk Management, as the second line of defence, is responsible for providing an independent view on liquidity risk on a consolidated basis to internal and external stakeholders and for managing the annual Internal Liquidity Adequacy Assessment Process (ILAAP). The Bank's ILAAP report is approved by the Board of Directors and submitted to the Central Bank of Iceland which then reviews the report in its SREP.

Liquidity Position

The Bank maintained a strong liquidity position throughout 2020 and all regulatory and internal metrics were above limits. The Bank continues to steer its liquidity ratios with the aim of reducing liquidity cost further while keeping the ratios comfortably above minimum requirements. The LCR ratio for the Bank in 2020 was 196%.

Funding

The Bank continues to be predominantly funded by deposits although borrowings through bond issuance amount to 38% of the total funding. The Bank has been gradually increasing its borrowing in recent years with the issuance of covered bonds and unsecured bonds in foreign and local currencies, as well as subordinated debt. Note 36 to the Annual Financial Statements gives an overview of the terms of outstanding bonds issued by the Bank at year-end 2020.

A key metric for assessing the long-term viability of the Bank's funding structure is the NSFR. The ratio measures the proportion of stable funding to long-term assets for a time horizon of over one year. In particular, the NSFR is structured to ensure that long-term assets are funded with at least a minimum amount of stable liabilities and thus to limit over-reliance on short-term wholesale funding. The NSFR ratio for the Bank in 2020 was 123%.

The EU LIQ2 in the Additional Pillar 3 Disclosure shows the breakdown of the Group's positions underlying the NSFR at year-end 2020.

Deposits

The loan-to-deposit ratio for households and non-financial corporations was 183% at year-end 2020 which is comparable to the 186% ratio at year-end 2019. The ratio is expected to remain in this range and deposits to continue to be the largest source of funding for the Bank in the years ahead.

The deposit balance rose by approximately ISK 70 billion over the course of the year 2020. The change was mainly due to an increase in retail deposits (ISK 53 billion), deposits from corporation (ISK 6 billion) and an increase in deposits from domestic and foreign financial institutions (ISK 7 billion) during the year.

The proportion of term deposits decreased from 28% of total deposits at year-end 2019 to 25% at year-end 2020. The decrease was mainly due to an increase in total deposits while term deposits remained stable. For a more detailed composition of deposits by LCR categories and term see Note 57 to the Annual Financial Statements.

Deposit concentration is monitored since a substantial amount of the Bank's deposits are held by relatively few counterparties. The Bank's highest deposit concentrations are in wholesale deposits from foreign and domestic financial institutions and pension funds. Deposit concentration has remained stable in the past year with 16-19% of the Bank's deposits belonging to the 10 largest depositors and 31- 34% belonging to the 100 largest depositors.

Asset Encumbrance

The asset encumbrance ratio is critical when monitoring the consequences of changes in funding sources and the ability to withstand funding stress. The Bank's asset encumbrance predominately consists of:

- loans and securities serving as collateral for covered bond issuance which is one of the Bank's strategic long-term funding sources;
- cash and securities as collateral for currency swap agreements; and
- Central Bank of Iceland term deposits for the payment system.

The Bank's asset encumbrance ratio was 18.7% at year-end 2020.

Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or external events. The Bank's definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at the Bank lies with the Board of Directors.

The operational risk management framework is based on the following principles:

- clear responsibilities and ownership of operational risk and operational risk controls;
- the Bank accepts no unnecessary operational risk, meaning that it only assumes operational risk when the cost of mitigating that risk and preventing possible losses outweighs the benefits;
- with the aim of ensuring business continuity and minimising customer impact the Bank shall have adequate processes, procedures and resources to ensure quick discovery, analysis and termination of IT incidents; define and meet service-level objectives for digital solutions, in line with the Bank's vision to be #1 in service; and protect information and data from loss of confidentiality;
- the Bank promotes a strong risk culture, emphasising compliance to internal and external laws and regulations;
- the Bank has no appetite for compliance risk that can lead to financial loss or loss of reputation;
- a key feature of a strong risk culture is to foster a "no blame" environment where operational risk events are recognised and registered to enable continuous improvement to the Bank's operations; and
- the Bank takes appropriate measures, in all its operations, to ensure the safety and health of its customers and employees.

The ARC is responsible for the review and implementation of the operational risk framework. The OSC decides on individual proposals for assuming and mitigating operational risk on behalf of the Bank within the appetite and limits approved by the Board and ARC. The OSC also reviews and approves proposals for new products, services, new outsourcing or other high-risk changes of systems or procedures within the Bank.

The managing directors for individual business and support divisions are responsible for the operational risk inherent in their business. This entails identifying the sources of operational risk in their operations, assessing whether the cost of avoiding the risk outweighs the benefits and ensuring that unacceptable operational risks are mitigated, and losses prevented.

Risk Management is responsible for implementing the Bank's operational risk framework, for developing and maintaining the Operational Risk Policy and for communicating the policy to the Bank's employees. Key risk factors related to operational risk are addressed in other policies such as the Security Policy, Outsourcing Policy and New Products and Material Changes Policy. These policies outline the risk management and internal controls specific to these risk categories.

Risk Management monitors the overall operational risk profile of the Bank, ensures proper escalation and reporting of operational risk issues and provides an independent view on the overall operational risk inherent in the Bank's operations. Furthermore, Risk Management is responsible for reporting on operational risk events and limit breaches to senior management, the Board of Directors and to the competent authorities in accordance with internal procedures and regulatory requirements.

In 2020, the overall responsibility for the Bank's compliance risk framework was transferred from the Compliance function to Risk Management. However, the Compliance function continues to be responsible for the risk management and compliance framework specific to measures concerning securities transactions and anti-money laundering in accordance to Icelandic law.

Anti-Money Laundering

In September 2019, the Financial Action Task Force (FATF) reassessed Iceland's measures to prevent money laundering and terrorist financing. Although several actions had been taken by Icelandic authorities to address previous observations by FATF, the task force concluded that the authorities had not yet ensured full compliance on all recommendations. As a result, FATF placed Iceland on the list of cooperative jurisdictions with strategic deficiencies. In October 2020, Iceland was removed from the list after FATF had found the supplementary measures taken by the government to by satisfactory.

Money laundering risks are identified in accordance with the AML Act. Procedures for monitoring money laundering risks include the collection and review of customer information and the monitoring of transactions in accordance with a risk-based approach. The Bank undertook the process of implementing new systems to comply with the AML Act in 2018 and 2019, including implementation of the FICO AML system, which bolstered the Bank's automatic monitoring capability and increased the share of automatic notifications of suspicious activity.

All employees receive regular training and information regarding changes in regulations and new trends and patterns, as well as regarding methods that may be used for money laundering and terrorist financing. The Bank has a process for providing information regarding suspicion of money laundering to the Icelandic Financial Intelligence Unit.

In March 2021, the FSA commenced a routine inspection of the risk management of the Bank in respect of anti-money laundering and terrorist financing with focus on cross-border transfer of funds pursuant to Rules No. 70/2019 and the freezing of funds pursuant to Act No. 64/2019. The inspection is still ongoing. Non-compliance may result in administrative fines being imposed.

To date, the Bank has not had any major AML incidents.

Sustainability Risk

Sustainability risk is the risk of being directly or indirectly negatively affected by externalities within the areas at environmental and climate considerations, anti-corruption, human rights, labour conditions, or business ethics. These risks are often defined by the materiality of ESG risk categories most significant for the company and its stakeholders.

Direct exposure includes the Bank's social licence to operate since damage to the Bank's reputation can cause customers or employees to leave the Bank for sustainability reasons. The Bank is indirectly exposed to sustainability risks in connection to its lending and investment activities.

The Bank has defined sustainability risk as a separate risk factor in its risk taxonomy and therefore the Pillar 3 report includes a chapter on the risk factor. This chapter is based on recommendations from the Task Force on Climate-related Financial Disclosures (TCFD) and thus comprises sections on Governance, Strategy, Risk Management, and Metrics and Targets.

The Board of Directors has approved the Sustainability Policy and sets the Bank's strategy and risk appetite in terms of sustainability risk. The Board is regularly updated on corporate sustainability matters and the usage of the Bank's Sustainable Financing Framework. The Corporate Governance and Human Resource subcommittee of the Board assists the Board in fulfilling its oversight responsibilities concerning sustainability.

The CEO is responsible for executing the strategy and has appointed a Sustainability Committee as a main building block of the governance structure. The Committee is the formal forum for discussions on all issues related to sustainability risk, sustainable procurement, and business opportunities. The Committee is independent from credit committees and needs to approve proposals for credit cases before they are included in the Sustainable Financing Framework. The Committee has senior representatives from business divisions, Finance, and Risk Management. It tracks eligible assets and proceeds in a sustainability registry and annually publishes the Bank's Allocation and Impact Report.

The Bank continues to further improve and develop how sustainability risk is identified, assessed, and managed within the Bank. Sustainability risk is a part of the Bank's Risk Taxonomy and entails both physical and transitional climate risk, as well as social and governance risk.

Supervisors have globally been directing attention to climate risk and its effect on financial stability and in some place's countrywide climate risk stress tests are planned. The Bank has started to perform exploratory climate stress tests scenarios against its portfolio. The aim of the analysis is to identify what sectors of the Bank's portfolio may have high adverse impacts on the environment and in which we have a significant number of customers. The sectors are then further analysed in comparison to the Climate Action Plan of the government of Iceland. The Bank will continue to further enhance the climate stress testing methodologies in the year 2021.

The Risk Appetite Statement now includes a qualitative statement on sustainability risk which is in line with the Bank's Sustainability Principles as stated in the Sustainability Policy. All new business or evaluating proposals in relation to existing business relationships shall aim for full alignment with the Sustainability Principles.

The Bank conducts regular training sessions for employees on climate risk to further enhance their abilities to engage with customers and to identify opportunities and threats related to climate related matters. Approximately 20% of the Bank's employees have received training on climate risk. The Bank intends to broaden the scope of the training to include social and governance matters as well.

Capital Management

Capital of banks is intended to provide a buffer for unexpected losses or volatility in earnings and thereby provide protection for depositors and other creditors as well as promoting stability of the financial system. The eligible capital for calculating the capital ratio is defined by law and further outlined in relevant rules and regulations. The applicable Icelandic laws defines both the type of eligible capital and restrictions to the reliance on specific instruments. The Bank's capital management framework is based on the CRD IV as transposed into Icelandic laws.

The Board of Directors is responsible for the Bank's capital management framework and for ensuring that the Bank's capitalisation is adequate in relation to the risk inherent in the operations considering the Bank's business strategy and operating environment. The Board defines the capital governance framework and the adequate capitalisation through the Risk Management and Internal Control Policy, the Risk Appetite Statement, and the Capital Management and Pricing Policy.

The ARC governs the capital management of the Bank in accordance with the capital targets set by the Board and reviews proposals to the Board regarding issues related to capital management, including the dividend policy.

The ALCO is responsible for capital allocation to the business divisions within the framework set by the Board. ALCO reviews and approves the contingency stage assessment as a part of the Bank's Liquidity and Capital Contingency Plan and reviews information about the capital adequacy position of the Bank with respect to targets and limits.

Risk Management is responsible for internal and external reporting on the Bank's capital adequacy. Risk Management is also responsible for the Bank's ICAAP and for the calculations of the allocated capital to individual business divisions.

Treasury is responsible for the management of the Bank's capital in accordance with the targets set by the Board. Finance is responsible for reporting on the risk-adjusted performance down to individual business divisions.

Total Capital and Capital Ratios

At 31 December 2020 the Bank's common equity Tier 1 (CET1) amounted to ISK 188 billion as compared to ISK 176 billion at year-end 2019. The main factors contributing to the increase in CET1 is the ISK 6.8 billion profit for the year and the implementation of regulation EU 2017/2395, as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds into Icelandic law in May 2020. The regulation allows for the phasing in of capital impacts due to IFRS 9, allowing institutions to include a predefined level of provisions as part of CET1 capital. The Bank elected to make use of the transitional arrangements, which added ISK 5 billion to CET1. The level of provisions included in CET1 is currently 70% of the incremental provision for credit risk, and will decrease to 50% in 2021, 25% in 2022 and finally to 0% in 2023.

As a response to COVID-19, the Bank did not pay any dividend during 2020. The Central Bank of Iceland issued a statement in the first half of 2020 endorsing EBA's call to institutions to refrain from the distribution of dividends, both to ensure that banks maintain a sound capital base and to provide the lending needed to support the economy.

The Bank's Tier 2 capital increased from ISK 23 billion to ISK 27 billion during the year 2020 due to the depreciation of the ISK against SEK in which all the Tier 2 issuance are denominated in SEK. A breakdown of the Bank's total capital base is set out below.

	As at 31 December	
Capital	**2020**	**2019**
	(ISK in millions)	
Common equity Tier 1 Capital	**187,869**	**175,648**
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,181	7,065
Retained earnings	113,529	105,569
Non-controlling interests	1,494	2,428
IFRS 9 reversal due to transitional rules	5,164	-
Fair value changes due to own credit standing	238	392
Tax assets	(259)	(476)
Intangible assets	(3,478)	(4,330)
Tier 2 capital	**27,194**	**22,674**
Qualifying subordinated liabilities	27,194	22,674
Total capital base	**215,063**	**198,322**

The Bank's minimum capital requirements, the corresponding risk exposure amount (REA) under Pillar 1, and the resulting capital ratios are shown in the table below.

Capital requirements and REA	Minimum capital requirements (Pillar I)	REA	Minimum capital requirements (Pillar I)	REA
	As at 31 December			
	2020		2019	
	(*ISK in millions*)			
Credit risk	**66,411**	**830,141**	**63,134**	**789,180**
Central governments or central banks	0	1	-	-
Regional governments or local authorities	171	2,137	189	2,358
Administrative bodies and non-commercial undertakings	92	1,147	75	940
Financial institutions	1,856	23,201	1,275	15,940
Corporates	40,643	508,032	39,731	496,642
Retail	10,828	135,352	10,753	134,408
Secured by real estate property	8,555	106,943	6,484	81,048
Exposure in default	2,436	30,445	2,166	27,072
Collective investment undertakings	91	1,140	94	1,172
Fair value shares, investment in associates and shares held for sale	690	8,630	1,073	13,412
Property, equipment, non-current assets held for sale and other assets	1,049	13,113	1,295	16,188
Market risk	**1,330**	**16,626**	**634**	**7,919**
Traded debt instruments	692	8,655	218	2,719
Shares and equity instruments	212	2,651	302	3,769
Currency risk	426	5,320	114	1,431
Credit valuation adjustment	138	1,728	162	2,027
Operational risk	6,802	85,026	6,834	85,424
Total	**74,681**	**933,521**	**70,764**	**884,550**
CET1 capital	–	187,869	–	175,648
Capital base	–	215,063	–	198,322
CET1 ratio	–	**20.1%**	–	**19.9%**
Total capital ratio	–	**23.0%**	–	**22.4%**

The REA increased by ISK 49 billion or 5.5% during the year. The largest increase was due to growth in the mortgage loan portfolio (ISK 42 billion), exposures to Financial institutions (ISK 7 billion) stemming from the foreign exchange liquidity portfolio, and increase in market risk exposure (ISK 9 billion), mainly due to a shift in the liquidity portfolio to bonds and debt instruments when the Central Bank of Iceland halted one-month term deposits. Finally, the implementation of IFRS 9 transitional arrangements contributed to an ISK 5 billion increase in REA. The REA decreased by ISK 14 billion when Article 501 in the CRR came into effect in Iceland on 1 January 2020. This article introduces the SME supporting factor that stipulates capital requirements deduction for credit risk on exposures to small and medium-sized enterprises.

Capital Requirements

The Board of Directors sets a minimum capital target for the Bank, expressed as the ratio between capital and risk exposure amount. The minimum capital target is intended to reduce the likelihood that the regulatory overall capital requirement is breached. The target is based on the results from ICAAP, the views expressed by the regulator through the SREP, implementation of the capital buffers and other factors such as uncertainties in the operating environment, a possible target rating, or other external factors. The following sections describe each component in more detail.

Pillar 1 Minimum Capital Requirements

The first pillar of the CRD IV defines the minimum capital requirements for credit risk, market risk, and operational risk. The minimum capital requirement under Pillar 1 is 8%, calculated as the ratio between the capital base and risk exposure amount.

For each of the Pillar 1 risk factors, the CRD IV allows for different methods to be used for calculating the minimum capital requirements and thereby REA. For credit risk and market risk, the Bank uses the standardised approach to calculate the capital requirements, and for operational risk the Basic Indicator Approach.

The total REA is determined by multiplying the capital requirements for market risk and operational risk by 12.5 (the reciprocal of the minimum capital ratio of 8%) and adding the resulting figures to the sum of REA for credit risk.

Pillar 2 Required Add-On (Pillar 2-R)

In addition to the minimum capital requirements for credit risk, market risk and operational risk under Pillar 1, financial institutions are required to make their own assessment of the overall capital requirements in the ICAAP/SREP process. These additional capital requirements, considering the risk profile of the institution, are referred to as Pillar 2-R capital requirements. The sum of Pillar 1 and Pillar 2-R is referred to as total SREP capital requirement (TSCR).

In the ICAAP 2020, the main factors contributing to additional capital requirements under Pillar 2-R for the Bank were:

- Additional capital requirements for risk factors underestimated under Pillar 1: Credit risk and market risk.

- Additional capital requirements for risk factors not addressed under Pillar 1: Credit concentration risk, IRRBB, market risk arising from equities in the banking book, and the inflation imbalance.

The Pillar 2-R capital requirements are presented as a proportion of REA and come as an addition to the regulatory capital minimum of 8% under Pillar 1. The Bank's Pillar 2-R results are reviewed by the Central Bank of Iceland through the SREP process which is performed annually. The financial uncertainty caused by COVID-19 has made it unusually difficult for the Central Bank of Iceland to determine asset quality and assess other risk in the Bank's operations. The Financial Supervision Committee therefore announced in September 2020 that the results of the 2019 SREP assessment concerning Pillar 2-R capital requirements shall remain unchanged. Developments in key risks in the Banks' operations will be monitored closely, and the additional capital requirement will be reviewed if need be, but no later than during the 2021 SREP. Based on the 2019 SREP, the additional capital required for the Bank under Pillar 2-R was 1.7% of REA.

The table below sets forth the breakdown of the total SREP capital requirement. The Pillar 2-R requirements for 2020 are based on unchanged results from 2019.

SREP capital requirement	**2020**	**2019**
Pillar 1	8.0%	8.0%
Credit risk	7.1%	7.1%
Market risk	0.2%	0.1%
Operational risk	0.7%	0.8%
Pillar 2-R	1.7%	1.7%
Credit risk	0.6%	0.6%
Credit concentration risk	0.5%	0.5%
Market risk	0.5%	0.5%
Subsidiaries	0.1%	0.1%
Total SREP capital requirement	**9.7%**	**9.7%**

Combined Capital Buffer Requirement

Four capital buffers are introduced through the CRD IV and applicable for Icelandic financial institutions: (1) Capital conservation buffer, (2) institution specific countercyclical buffer, (3) buffer for systemically important institutions, and (4) systemic risk buffer. Together these buffers form the combined buffer requirement. The capital buffers are generally intended to enhance banks' ability to withstand adverse changes in the environment and reduce fluctuations related to the business cycle.

The size of the capital conservation buffer is fixed by law at 2.5%. The size of the other capital buffers is stipulated in Rules 227/2020, 323/2020 and 324/2020 issued by the Central Bank of Iceland.

In March 2020, the Central Bank of Iceland reduced the countercyclical capital buffer from 2% to 0% as a response to COVID-19. According to the Central Bank of Iceland's statement, the countercyclical buffer will not be increased for at least 12 months and will therefore remain unchanged at 0% at least until the first quarter of 2022.

As the systemic risk buffer only applies to domestic exposures, the effective risk buffer rate is calculated by multiplying the proportion of the domestic credit risk exposure by the domestic systemic risk buffer rate.

The institution-specific countercyclical capital buffer rate applies to institution-wide total REA. The institution's specific buffer add-on amount is calculated as the weighted average of the countercyclical capital buffer rate applicable in jurisdictions in which an institution has private sector credit exposures, multiplied by the total risk exposure amount.

The calculations of the institution specific buffer rates are displayed in the first table below while the second shows combined buffer requirement for the Bank at year-end 2020 and 2019. The sum of Pillar 1, Pillar 2-R and the combined capital buffers forms the overall capital requirement.

	Contributing credit risk REA	Contributing market risk REA	Total contributing REA	Buffer rate	Institution specific buffer rate
Countercyclical capital buffer					
Iceland	764.2	2.2	766.3	0.00%	0.00%
Norway	2.5	0.0	2.5	1.00%	0.00%
Other countries with effective countercyclical buffers	0.1	–	0.1	0.33%	0.00%
Other countries	36.9	0.0	36.9	–	–
Total	**803.7**	**2.2**	**805.8**	–	**0.0032%**
Systemic risk buffer					
Iceland	768.5	–	768.5	3.00%	2.78%
Other countries	61.7	–	61.7	0.00%	0.00%
Total capital ratio	**830.1**	–	**830.1**	–	**2.78%**

	31.12.2020	31.12.2019
Capital conservation buffer	2.50%	2.50%
Countercyclical capital buffer	0.00%	1.68%
O-SII buffer	2.00%	2.00%
Systemic risk buffer	2.78%	2.81%
Combined buffer requirement	**7.28%**	**8.99%**

Pillar 2 Guidance for Stressed Conditions (Pillar 2-G)

The Pillar 2-G is based on future risk and is subject to the regulators' assessment of stress tests performed on the financial institutions (supervisory stress testing). The Central Bank of Iceland can add the Pillar 2-G as a capital reference if the results from the supervisory assessment indicate that a financial institution might not be able to meet the total SREP capital requirements over the projected economic cycle. Currently no Pillar 2-G is applicable for the Bank.

Management Buffer

The Bank aims at managing its capital position and the corresponding capital ratios at a comfortable margin above the overall regulatory capital requirement. This margin is referred to as the management buffer in the Bank's capital management framework. The size of the management buffer is based on factors such as views from the regulator through the SREP, volatility in the Bank's REA due to currency fluctuation, volatility in the Bank's REA due to lumpy asset growth, the Bank's target rating, competitive issues, funding terms, uncertainty in the operating environment not accounted for in the ICAAP, and uncertainty in the regulatory environment. Currently, the management buffer is set by the Board of Directors at 0.5%-2.0%.

Capital Target

The Bank's capital target set by the Board of Directors assumes that the Bank keeps a management buffer of about 0.5–2.0% in excess of the overall capital requirement resulting from the SREP. Based on the most recent SREP results, this translates to a target capital ratio of 17.5–19.0%. In addition to the call from the Central Bank to refrain from dividend disbursement, due to the uncertainty in relation to the effects of COVID-19 on the capital base, the Bank aims to have an ample buffer in excess of the current target until there is further clarity regarding public health restrictions, international travel and other sources of uncertainty.

In January 2021, the Financial Supervision Committee published amended guidelines on financial institutions' and insurance companies' dividend payments and purchases of their own shares, which remain in effect through 30 September 2021 in light of the COVID-19 pandemic. The guidelines do not expressly object to payments of dividends but financial institutions are urged to be guided by certain prudent considerations on capital position.

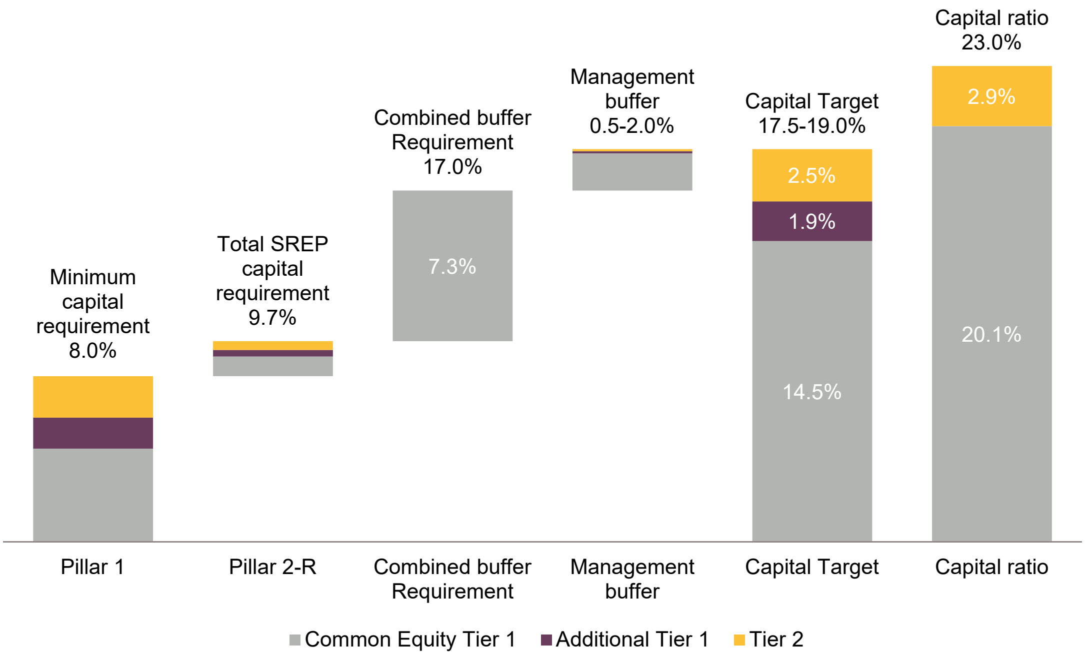
Capital Composition

According to the CRD IV, the following restrictions apply to the composition of Pillar 1 capital:

- CET1 at a minimum 4.5% of REA.
- Tier 1 capital, including Additional Tier 1 (AT1) at a minimum 6.0% of REA.
- A total capital ratio including Tier 2 debt at a minimum 8.0% of REA.

The capital held under Pillar 2-R is subject to the same proportional restrictions as capital held under Pillar 1, the CRD IV capital buffers shall be comprised of CET1 capital only, whereas the composition of the management buffer is at the Bank's discretion.

The chart below shows the Bank's current regulatory requirements from the 2020 SREP results and how they contribute to the Group's capital target as well as the composition of the Bank's capital, the minimum requirements for CET1 capital, and the resulting room for issuing AT1 or Tier 2 capital.



Stress Testing

The Bank's stress testing framework aims at detecting the sensitivity of the Bank's operations to changes in the operating environment and to ensure that the Bank holds sufficient available capital and liquid funds to meet minimum requirements, even under stressed operational conditions.

The main types of stress tests performed at the Bank are:

- Sensitivity analysis: Sensitivity analyses provide information about key risks and enhance understanding about concentrations in one or several risk factors. Sensitivity analysis stresses one risk driver, with different degrees of severity, to assess the sensitivity of the Bank's operations to that particular risk driver.
- Reverse stress test: Reverse stress testing consists of defining a significant and pre-defined negative outcome and then identifying causes and consequences that could lead to such an outcome. The purpose is to identify possible combinations of events and risk concentrations that might not be included in other stress tests performed within the Bank. Thus, the reverse stress test could reveal weaknesses in the Bank's operations that might otherwise be overlooked.
- Scenario analysis: Scenario analysis can be defined as multiple sensitivity analyses performed at the same time which assess the resilience of an institution. A stress scenario is supposed to be forward looking and identify possible events or changes in market conditions that could adversely impact the

Bank. The scenario should address the main risk factors that the Bank may be exposed to. The scenario should be severe but plausible and at the same time be consistent internally as well as economically. The Bank has recently added climate risk as one of the risk factors in the scenario analysis.

- Specific events: Under this type of stress testing, the Bank assesses specific current or imminent events that could have an extensive impact on its operations, the risk mitigating actions that can be taken to reduce the likelihood of these events materialising and to minimise the impact for the Bank.

- Reputational risk stress test: Qualitative stress testing due to reputational risk are performed by experts from across the Bank. The experts come up with a scenario that could damage the Bank's reputation and analyse how the scenario affects the Bank's reputation, the impact it has on different stakeholders, the likelihood that it would have this effect and discuss possible countermeasures. The discussions are documented and summarised in the Bank's ICAAP Stress Testing Results.

The key assumptions for a scenario analysis and other significant stress tests are developed in cooperation with the Bank's Chief Economist, business divisions, ARC and the Board. The results from stress tests are compared with the Bank's capital target, other risk appetite measures and risk limits. If the results indicate a breach in the Bank's capital targets or other risk appetite or strategic measures, remedial actions may be suggested, depending on the severity and likelihood of such a breach.

In addition, the Central Bank of Iceland conducts an annual stress test on Icelandic banks to examine the potential impact of hypothetical stress scenarios on the Icelandic banking system as a whole and certain Icelandic banking institutions. The stress scenario is designed with regard to the Central Bank of Iceland's assessment of current risks to financial stability in Iceland. The test is part of the Central Bank of Iceland's macroprudential supervision program and includes a cyclical stress scenario.

Leverage Ratio

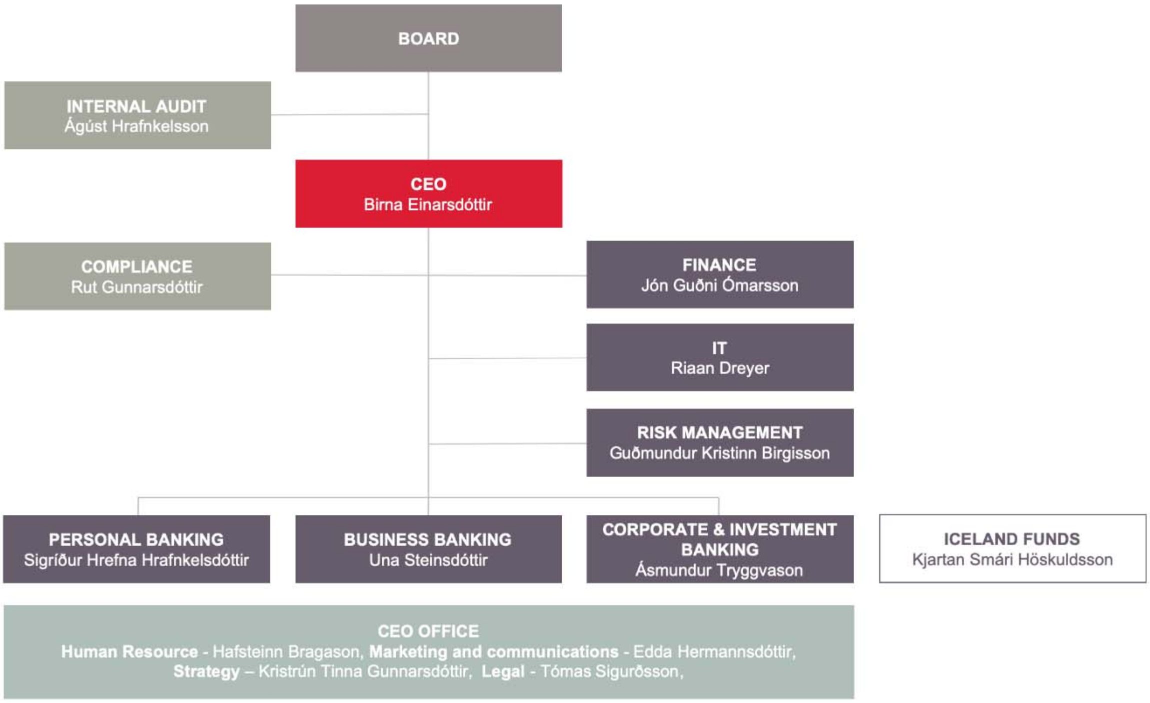
The leverage ratio is a measure supplementing the risk-based capital requirements. A lower leverage ratio indicates higher leverage. The leverage ratio is calculated by dividing Tier 1 capital by the sum of total assets and adjusted off-balance sheet exposures. According to law, the minimum leverage ratio is 3%.

The table below shows the breakdown of the exposures and the leverage ratio. The increase in the total exposure measure is due to a larger balance sheet whereas the increase in the Tier 1 capital is due to retained earnings. As a result, the leverage ratio decreased slightly between years.

	As at 31 December	
	2020	**2019**
On-balance sheet exposures	1,334	1,189
Off-balance sheet exposures	41	39
Derivative exposures	10	9
Leverage ratio total exposure measure	1,385	1,237
Tier 1 capital	188	176
Leverage ratio	**13.5%**	**14.2%**

BOARD OF DIRECTORS, EXECUTIVE COMMITTEE, AUDITOR AND CORPORATE GOVERNANCE

The chart below illustrates the Bank's principal operating and support functions, including the Board of Directors and the Executive Committee, each of which is described in greater detail below.



Board of Directors

Overview

The Bank's Board of Directors consists of seven directors, elected for a term of one year at each AGM of the Bank. Two alternate members are also appointed to each AGM for a term of one year. The Board of Directors appoints the Chief Executive Officer and the Chief Audit Executive. The Chief Executive Officer appoints the Managing Directors of the Bank.

The Board of Directors is responsible for setting out the Bank's general strategy and instructs the Chief Executive Officer on its implementation and execution. The Board of Directors have a supervisory role and are responsible for overseeing that the Bank's organisational structure and activities are in compliance with the relevant law, regulations and good business practices at all times.

According to the Board Rules of Procedure, at least five members of the Board of Directors are required to constitute a quorum at meetings of the Board of Directors. The current Board of Directors were nominated through a selection process administered by the Selling Shareholder in accordance with Article 7 of Act No. 88/2009 on Icelandic State Financial Investment.

With amendments to the Bank's Articles of Association approved at a shareholders' meeting of the Bank on 26 May 2021 a Nomination Committee was established, whose main role is to nominate individuals to the Bank's Board of Directors. The Articles of Association authorise the Board of Directors to appoint members to the committee which shall consist of three members, appointed annually for a term of one year. Two of the Committee's members shall be independent of the Bank and its day-to-day management. The third member of the Committee shall be the chairman of the Board of Directors.

The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board of Directors is comprised of three women and four men. The Board of Directors have approved a policy on the suitability of the Board of Directors, the Chief Executive Officer and key function holders. The policy states, among other things, that the composition of the Board shall at all times be diverse, with regard to educational and professional background, gender and age.

At least once a year, pursuant to the Boards Rules of Procedure, the Board of Directors assess their work, procedures and practices as well as those of each of its members. This performance assessment is intended to improve working methods and increase the efficiency of the Board of Directors and entails an evaluation of the strengths and weaknesses of the Board of Directors' work and practices which is based on an assessment of the necessary number of board directors, the board structure in relation to knowledge and experience, board procedure and practices. Further, the Board of Directors annually assesses the collective suitability of the Board of Directors and individual members.

All members of the Board of Directors are considered independent from the Bank, its main clients, competitors and the Selling Shareholder.

The business address of each director is Íslandsbanki hf., Hagasmári 3, 201 Kópavogur, Iceland.

Set forth below are the members of the Bank's Board of Directors, their year of birth, the year of their initial election to the Board of Directors, their position and whether or not they are considered to be independent of the Bank and the Selling Shareholder pursuant to the Corporate Governance Guidelines and the corporate governance statement of the Bank (*stjórnarháttayfirlýsing*), as confirmed by the Bank's Board of Directors on 10 February 2021:

Name	**Position**	**Year of birth**	**Director since**	**Independent**
Hallgrímur Snorrason	Chairman of the Board of Directors	1947	2016	Yes
Anna Þórðardóttir	Member of the Board of Directors	1960	2016	Yes
Árni Stefánsson	Member of the Board of Directors	1966	2016	Yes
Frosti Ólafsson	Member of the Board of Directors	1982	2020	Yes
Guðrún Þorgeirsdóttir	Member of the Board of Directors	1979	2020	Yes
Heiðrún Jónsdóttir	Member of the Board of Directors	1969	2016	Yes
Jökull H. Úlfsson	Member of the Board of Directors	1963	2021	Yes

Mr. Hallgrímur Snorrason (Chairman of the Board of Directors)

Hallgrímur is an independent consultant in official statistics at international level. He was Director-General of Statistics Iceland from 1985 to 2007 and Deputy Managing Director of the National Economic Institute of Iceland from 1980 to 1984. He has been a member of the board of several companies, including Útvegsbanki Íslands hf., Skýrr and Auður Capital, and has chaired or served on a number of governmental committees, both domestically and in connection with Nordic Cooperation, EFTA, EU and the OECD. Mr. Snorrason holds an M.Sc. degree in Economics from the University of Lund in Sweden and a B.Sc. degree in Economics from the University of Edinburgh.

Ms. Anna Þórðardóttir (Member of the Board of Directors)

Anna has been a board member of several companies and organisations, including KPMG, Heimstaden and the Institute of State Authorised Public Accountants in Iceland. She is currently a member of the board of The Icelandic Center for Future Studies (*Framtíðarsetur Íslands*) and is chairman of the Board Audit Committee of Hagar. Anna was an employee of KPMG in 1988-2015, where she became partner in 1999. While at KPMG, she was responsible for the audit of the following companies: Reitir, Hagar, 365, Baugur Group, Vodafone, Landfestar, Landey, 10-11 and Félagsbústaðir. Anna holds a Cand Oecon. in Business Administration from the University of Iceland and is a Chartered Accountant. She has also studied towards a Cand. Merc in Financial studies from Handelhøjskolen in Aarhus, Denmark.

Mr. Árni Stefánsson (Member of the Board of Directors)

Árni has extensive management experience in power-intensive industry in Iceland and is currently manager and member of the executive board at the Rio Tinto primary aluminium plant. Previously, he was a manager of the Century Aluminium plant Norðurál in Grundartangi; manager and in the executive board with Landsnet, the electric transmission grid company of Iceland; and manager with Landsvirkjun, the National Power Company of Iceland. Árni holds an M.Sc. in electrical engineering.

Mr. Frosti Ólafsson (Member of the Board of Directors)

Frosti is an independent strategic consultant. He is the former CEO of ORF Genetics, a leading plant biotechnology company that owns and operates BIOEFFECT skin care brand, was the Managing Director of Iceland Chamber of Commerce and worked as a strategic consultant for McKinsey & Company. In his past roles, Frosti has supported leading domestic and international companies on a wide range of topics, including strategy, operations and governance. Frosti is currently a member of the board of directors at Reykjavik University and affiliated real estate entities, of Freyja Private Equity Fund and of Controlant. Frosti holds an MBA degree from London Business School and a B.Sc. degree in economics from University of Iceland and Macquarie University in Sydney.

Ms. Guðrún Þorgeirsdóttir (Member of the Board of Directors)

Guðrún is the Chief Business Development Officer of PayAnalytics. Previously, Guðrún was the Chief Financial Officer of Skeljungur. Guðrún has prior experience as a Chief Risk Officer and as an investment manager. Guðrún is an experienced board member and has served on the board of directors of insurance companies, financial companies and retail and service companies, including VÍS, Lífís, Lyfja and Lýsing. Guðrún has a B.Sc. in Industrial Engineering from the University of Iceland, an MBA from HEC School of Management in France and is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs.

Ms. Heiðrún Jónsdóttir (Member of the Board of Directors)

Heiðrún is an attorney at law with Múli Legal Services and serves as a member of the board of Reginn real estate company and Royal Arctic Line. Previously, she was Managing Director at Eimskipafélag Íslands, Lex Legal Services, and Legal and Human Resources at KEA. She has been chairman of the board at Norðlenska, Íslensk Verðbréf and Gildi pension fund and has been a member of the board of Síminn, Icelandair Group and Olíuverslun Íslands, the Icelandic Banks' Data Centre (RB), Ístak, the securities depository Arion Verðbréfavarsla, Þekking and the Icelandic Pension Funds Association. Heiðrún serves as a board member of the board of the Icelandic Bar Association form 2016-2019 and was the deputy chairman of the board from 2018-2019. Heiðrún holds a Cand. Jur from the University of Iceland and is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs. She completed an Advanced Management Program (AMP) at IESE Business School in Barcelona in 2017.

Mr. Jökull H. Úlfsson (Member of the Board of Directors)

Jökull has worked in the financial market for the past 25 years where he has acquired comprehensive knowledge on financial institutions' operations. Jökull has spent most of his career for Arion Bank hf. and its predecessors as a manager in asset management, business development, and human resources. He sat on the Board of directors of Stefnir hf. in the years 2013 to 2019 and was Managing Director of Stefnir hf. from 2019 to 2020. Jökull holds a cand. oceon. degree in business administration from the University of Iceland and is a certified securities broker.

Set forth below are the alternate members of the Bank's Board of Directors, their year of birth, the year of their initial election to the Board of Directors, their position and whether or not they are considered to be independent of the Bank and the Selling Shareholder pursuant to the Corporate Governance Guidelines and the corporate governance statement of the Bank (*stjórnarháttayfirlýsing*), as confirmed by the Bank's Board of Directors on 10 February 2021:

Name	**Position**	**Year of birth**	**Director since**	**Independent**
Mr. Óskar Jósefsson	Alternate Member of the Board of Directors	1957	2020	Yes
Ms. Herdís Gunnarsdóttir	Alternate Member of the Board of Directors	1968	2016	Yes

Ms. Herdís Gunnarsdóttir (Alternate Member of the Board of Directors)

Herdís is the director of The Icelandic Social Insurance Administration's rights division. Herdís holds an MBA degree from the University of Iceland and an MSc and BSc in Nursing from the University of Iceland.

Mr. Óskar Jósefsson (Alternate Member of the Board of Directors)

Óskar holds a M.Sc. degree in industrial and operations engineering from Aalborg University in Denmark. He is the chief executive officer of Iceland Tourism Task Force since 2016 and has been a member of the executive management and board of directors of several leading companies in Iceland.

Subcommittees of the Board of Directors

The Board of Directors has three subcommittees and they operate under the terms of a mandate letter from the Board of Directors as well as the Board Rules of Procedure. The Board of Directors appoint the members of the subcommittees as well as their chairman. When appointing the subcommittees, the Board of Directors consider the expertise, skills and experience needed of a member to be appointed to the relevant subcommittee. All of the subcommittees are comprised of members of the Board of Directors and the majority of the subcommittee members are independent from the Bank.

Sub-committees of the Board of Directors shall ensure that Directors receive regular and specific information on the main functions of the committees and at least once a year report to the Board on their work. All Directors shall have access to the minutes of sub-committees. The appointment of sub-committees does not free the Board of Directors from its responsibilities and the decision-making power rests with the Board of Directors at all times.

The table below sets forth the membership on each of the committees of the Board of Directors as at the date of this Prospectus.

The Board Audit Committee	The Board Risk Management Committee	The Board Corporate Governance and Human Resources Committee
Anna Þórðardóttir, chairman	Árni Stefánsson, chairman	Heiðrún Jónsdóttir, chairman
Frosti Ólafsson	Guðrún Þorgeirsdóttir	Frosti Ólafsson
Hallgrímur Snorrason	Jökull H. Úlfsson	Guðrún Þorgeirsdóttir

The Board Audit Committee

The Board Audit Committee has three members Anna Þórðardóttir, Frosti Ólafsson and Hallgrímur Snorrason, and assists the Board of Directors in fulfilling its oversight responsibilities concerning the financial reporting process, system of internal control, the audit process and the Bank's process for monitoring compliance with the relevant laws and regulations and its code of conduct. The Board Audit Committee met six times during the year ended 31 December 2020.

The Board Risk Management Committee

The Board Risk Management Committee has three members Árni Stefánsson, Guðrún Þorgeirsdóttir and Jökull H. Úlfsson and assists the Board of Directors in providing oversight of senior management activities in managing risk relevant to the Bank's operations. This includes credit risk, market risk, operational risk, liquidity risk, compliance risk and reputational risk. The committee's responsibilities extend to the Group. The Board Risk Management Committee met nine times during the year ended 31 December 2020.

The Board Corporate Governance and Human Resources Committee

The Board Corporate Governance and Human Resources Committee has three members Heiðrún Jónsdóttir Frosti Ólafsson, and Guðrún Þorgeirsdóttir and assists the Board of Directors in overseeing the development and the regular assessment of the Bank's approach to corporate governance issues and board effectiveness. Furthermore, it is responsible for providing oversight regarding compensation and human resource issues. The Board Corporate Governance and Human Resources Committee met seven times during the year ended 31 December 2020.

Roles and responsibilities of the Board of Directors

The Board of Directors' tasks include, among others, as defined in the Board Rules of Procedure:

(a) The Board is responsible for the Bank's operations and policy, including its risk policy, and instructs the CEO on its implementation and execution.

(b) The Board shall take the lead, together with the CEO, in strategic planning, formation of the Bank's business plan, and the setting of goals and risk parameters for the Bank, for short and long term.

(c) The Board shall set and maintain a clear internal governance structure and internal control framework appropriate to the Bank's infrastructure, operations and risk factors in accordance with the applicable laws, regulations, decisions by the competent authorities or agreements regarding independence or administrative separation from subsidiaries.

(d) The Board monitors that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations, good governance and business practices and rules set by the Board.

(e) The Board is responsible for the hire and dismissal of the Bank's CEO and decides his/her remuneration.

The Chief Executive Officer

The Chief Executive Officer is responsible for the day-to-day operations of the Bank and ensuring the Bank's compliance with its Articles of Association, policies, and applicable law. The CEO engages the Bank's Compliance Officer, subject to confirmation by the Board of Directors and appoints members of the Executive Committee and other Senior Management Committees.

Executive Committee

Overview

The Executive Committee, chaired by the Chief Executive Officer, is responsible for implementing the business strategy approved by the Board of Directors. The Executive Committee and All Risk Committee are responsible for the implementation of the Board of Directors approved business strategy, risk appetite, policies and business committees.

Members of the Executive Committee

The table below sets forth the members of the Executive Committee, their year of birth and the year in which they were appointed to their current positions on the Executive Committee.

Name	Position	Year of birth	Appointed
Birna Einarsdóttir	Chief Executive Officer	1961	2008
Jón Guðni Ómarsson	Chief Financial Officer	1976	2011
Guðmundur Kristinn Birgisson	Chief Risk Officer	1967	2018
Riaan Dreyer	Managing Director, Information Technology	1975	2019
Sigríður Hrefna Hrafnkelsdóttir	Managing Director, Personal Banking	1977	2017
Una Steinsdóttir	Managing Director, Business Banking	1966	2008
Ásmundur Tryggvason	Managing Director, Corporate and Investment Banking	1975	2019

The business address of each member of the executive board committee is Íslandsbanki hf., Hagasmári 3, 201 Kópavogur, Iceland.

The Executive Committee consists of the following seven members:

Ms. Birna Einarsdóttir, Chief Executive Officer

Birna Einarsdóttir worked at Iðnaðarbankinn hf., a predecessor of the Bank, from 1987. After six years with Royal Bank of Scotland as Senior Product Manager, Ms. Einarsdóttir re-joined the Bank in the fall of 2004 as the Managing Director of Sales and Marketing. She was appointed Executive Vice President of Retail Banking of August 2007. Ms. Einarsdóttir assumed the role of Chief Executive Officer of the Bank in October 2008. Ms. Einarsdóttir has as well worked as Head of Marketing for the Icelandic Broadcasting Company Ltd. (Channel 2) and Managing Director for the Icelandic Football Pools (Íslensk getspá).

Ms. Einarsdóttir holds a B.Sc. degree in Business Administration from the University of Iceland and an MBA degree from the University of Edinburgh.

Mr. Jón Guðni Ómarsson, Chief Financial Officer

Jón Guðni Ómarsson worked in the Capital Markets division at the Bank from 2000 to 2002. He re-joined the Bank in 2005 and has held various positions in the Leverage Finance and Treasury divisions, working on different types of investment and funding transactions. In October 2008, he was appointed Executive Director of Treasury of the Bank and in October 2011, he was appointed Chief Financial Officer of the Bank. He also worked as an ALM consultant at SunGard in Boston.

Mr. Ómarsson holds a B.Sc. degree in Industrial and Mechanical Engineering from the University of Iceland and a Master's degree in Quantitative and Computational Finance (QCF) from the Georgia Institute of Technology. He is a Chartered Financial Analyst (CFA) and a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs.

Mr. Guðmundur Kristinn Birgisson, Chief Risk Officer

Guðmundur Kristinn Birgisson joined the Bank in 2011 as Executive Director of Risk Monitoring where he oversaw the implementation of the Bank's Operational Risk Management Framework and monitoring of the execution of credit processes. In 2017, he served as Executive Director of Lending in the Bank's Personal Banking division and, in 2018, he was appointed as the Chief Risk Officer of the Bank. Mr. Birgisson holds a Ph.D. degree in Mathematics Education from Indiana University and a B.A. in Philosophy and Science from the University of Iceland.

Mr. Riaan Dreyer, Managing Director, IT

Riaan Dreyer has been with the Bank since 2019. Mr. Dreyer has been in various Chief Information Officer roles in South Africa, most notably Standard Bank and Liberty Life before he relocated to Iceland in 2016. He then joined Meniga in 2016 after which he joined Arion Bank as the Head of Development from 2017 to 2019. Mr. Dreyer holds a Master's degree in Information Technology from the University of Pretoria, South Africa and a Bachelor's degree in Actuarial Science and Economics. He has completed an AMP management programme from IESE Business School, Barcelona.

Ms. Sigríður Hrefna Hrafnkelsdóttir, Managing Director Personal Banking

Sigríður Hrefna Hrafnkelsdóttir was appointed Managing Director of Personal Banking of the Bank in May 2017. Ms. Hrafnkelsdóttir worked as managing director of retail for Olíusverzlun Íslands from 2014. Before that she worked for Arion Bank, Sparisjóðabanki Íslands, Atlas Ejendomme A/S and LEX Law Offices. She has also served on the boards of various companies, both in Iceland and abroad. Ms. Hrafnkelsdóttir holds a Cand. Jur. degree from the University of Iceland, is a district court attorney and holds an MBA degree from Copenhagen Business School.

Ms. Una Steinsdóttir, Managing Director Business Banking

Una Steinsdóttir joined the Bank in 1991 as a specialist in International Banking. Ms. Steinsdóttir has over 30 years of experience working for the Bank and its predecessors and has, among other things, worked in credit control and service management. Ms. Steinsdóttir was a branch manager in Keflavik for eight years from 1999 to 2007 until she was appointed Director of Retail Banking in 2007. She was then appointed Managing Director of Retail Banking for the Bank in October 2008. Ms. Steinsdóttir holds a Cand. Oecon degree in Business Administration from the University of Iceland and has completed an AMP management programme from IESE Business School, Barcelona.

Mr. Ásmundur Tryggvason, Managing Director Corporate and Investment Banking

Ásmundur Tryggvason was the Executive Director of the Bank's Corporate Finance department from 2012 to 2019. Mr. Tryggvason has also worked in the Bank's Research department and in Business Banking. He has also served on the boards of various financial, technology, industrial, telephone and publishing companies. Mr. Tryggvason holds a law degree from the Faculty of Law of the University of Iceland, is a District Court Attorney and is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs.

Business Committees

The business committees decide on individual business proposals in accordance with the rules and procedures issued by the All Risk Committee and the Board of Directors. All business proposals discussed by the business committees are initiated and owned by a business division and although authorisation is given by a committee, the business decision itself is made and owned by the business division.

The Senior Credit Committee: decides on proposals on lending and is the formal venue for discussion and review of individual loan proposals.

The Asset and Liability Committee: decides on proposals regarding market risk, liquidity risk, funding, capital and internal and external pricing.

The Investment Committee: decides on proposals regarding the purchase, sale and valuation of equity stakes and other investments of the Bank.

The Operational and Security Committee: decides on proposals regarding new products and services, continuous operation and material changes in systems and procedures.

The Sustainability Committee: is a formal forum for reviewing and discussing issues related to sustainability risk, sustainable procurement and business opportunities.

Other Information on the Board of Directors and the Executive Committee

None of the members of the Board of Directors own shares or options in the Bank, neither as a direct ownership nor through associated parties.

No member of the Board of Directors or the Executive Committee has been involved in bankruptcy, mandatory liquidation or bankruptcy administration in the past five years in their respective capacity as member of the Board of Directors or the Executive Committee. No member of the Board of Directors or the Executive Committee has been convicted in any case relating to fraud in the past five years. No member of the Board of Directors or the Executive Committee has in the past five years have had any official public incrimination and/or sanctions by statutory or regulatory authorities. No member of the Board of Directors or the Executive Committee has in the past five years been banned by any court from membership of a company's administrative, management or control bodies or from holding management or general positions within a company.

Other Directorships

The table below sets forth the companies and partnerships (excluding the Bank) in which each member and alternate member of the Board of Directors and each member of the Executive Committee is, or has been, a member of the administrative, management or supervisory bodies (or partner) at any time in the previous five years and whether he or she is still a member.

Name	Company / Partnership	Position	Position still held (Y/N)
Anna Þórðardóttir	YY2 ehf.	Director	N
	XX1 slhf.	Director	N
	Heimstaden ehf.	Director	N
	Framtíðarsetur Ísland ehf.	Director	Y
Árni Örn Stefánsson	Klafi ehf.	Alternate director	N
Ásmundur Tryggvason	GP ÍSF ehf.	Director and CEO	N
Birna Einarsdóttir	Menntasjóður Viðskipta.Íslands	Director	Y
	Viðskiptaráð Íslands	Director	Y
	Samtök atvinnulífsins	Director	Y
Frosti Ólafsson	Menntasjóður Viðskipta.Íslands	CEO	N
	Icelandic Chamber of Commerce	Director	N
	Gló Biopharma ehf.	CEO	N
	Hástoð ehf.	Director	N
	Nauthólsvegur 83 hses.	Director	Y
	Óson ehf.	Director and owner	Y
	Háskólinn í Reykjavík ehf.	Director	Y
	FREYJA framtakssjóður slhf.	Director	Y
	Nauthólsvegur 85 hses.	Director	Y
	Controlant hf.	Director	Y

Name	Company / Partnership	Position	Position still held (Y/N)
Guðmundur Kristinn Birgisson	Grunnstoð ehf.	Director	Y
	Sálarstyrkur ehf.	Chairman of the board of directors	
Guðrún Þorgeirsdóttir	Pavonis ehf.	Owner and alternate director	Y
	Tharsis ehf.	Owner and CEO	Y
Hallgrímur Snorrason	—	—	—
Heiðrún Emilía Jónsdóttir	Síminn hf.	Director	N
	Olíuverzlun Íslands ehf.	Director	N
	Icelandair Group hf.	Director	N
	Icelandair ehf.	Director	N
	Reginn hf.	Director	Y
	Múli lögmannsstofa ehf.	Director, owner and CEO	Y
	Fjeldsted & Blöndal slf.	Partner	N
	Royal Arctic Line	Director	Y
Herdís Gunnarsdóttir	—	—	—
Jökull H. Úlfarsson	Stefnir hf.	Director	N
Jón Guðni Ómarsson	Armis ehf.	Alternate director	Y
Óskar Jósefsson	Miðbæjarhótel/Centerhotels ehf.	Director	N
	ePóstur ehf.	Director	N
	Auðkenni ehf.	Chairman of the board of directors	N
	Þróunarfélag Krók- Hestháls ehf	Alternate director	N
	Móóm ehf.	Chairman of the board of directors	N
	Vörukaup ehf.	Director	Y
	Þarfaþing hf.	Director	Y
	Míla ehf.	Chairman of the board of directors	Y
	Framkvæmdafélagið Skjald. ehf.	Director	Y
	Advance ehf.	Director	Y
	Advance ehf.	CEO	Y
	Rekstrarþjónustan ehf,Garðabæ	Director and owner	Y
	Lögskipti ehf	Alternate director	Y
	Green Atlantic Data Centers ehf	Director	Y
Sigríður Hrefna Hrafnkelsdóttir	Xyzeta ehf.	Chairman of the board of directors and owner	Y
	Dagsól ehf.	Director	N
	Áltak ehf.	Director	N
	Reginn hf.	Director	N
	Ígló ehf.	Director	N
	Sjónlag hf.	Chairman of the board of directors	Y
	Brunnur vaxtarsjóður slhf.	Alternate director	Y
Una Steinsdóttir	Íslenska óperan ses.	Director	N

Potential Conflict of Interest

The Bank has listed three situations as a possible conflict of interest situation.

- Frosti Ólafsson, a member of the Board of Directors of the Bank, is a director at Freyja framtakssjóður, a fund operated by Kvika Asset Management, one of the competitors of Iceland Funds.

- Brynja Baldursdóttir, the spouse of Jón Guðni Ómarsson, the Bank's Chief Financial Officer, is a managing director of Creditinfo Lánstraust hf., which is a customer of the Bank and a director at Fossar markaðir hf., one of the Bank's competitors.
- Jón Þór Sigurvinsson, the spouse of Guðrún Þorgeirsdóttir, a member of the Board of Directors, is the head of corporate finance and one of the founders of Arctica Finance hf., one of the Bank's competitors.

Besides that, no member of the Board of Directors or the Executive Committee has any private interest that might conflict with the Bank's interests.

Independent Auditor

In accordance with Article 4 of Act No. 46/2016 on the Auditor General and auditing of central government accounts, external auditing of public limited companies in which the Icelandic state is the majority owner is the responsibility of the Auditor General. Furthermore, the provisions of the Act allow the Auditor General to contract external auditors, audit firms and other specialists to work on his/her behalf on individual tasks that the Icelandic National Audit Office ("**INAO**") is responsible for. Under its previous ownership, the Bank selected Ernst & Young ehf. as its external auditors based on a selection process run by the Audit Committee. Following the Icelandic state's acquisition of all shares in the Bank, Ernst & Young ehf. has carried on their duties as external auditors based on arrangements with INAO. Upon expiration, the agreement was extended for an additional two years, the current fiscal year being the latter.

The Bank's finance division is responsible for the preparation of the Group's consolidated financial statements in line with the IFRS as adopted by the Annual Accounts Act, the Financial Undertakings Act and Rules No. 532/2003 on Accounting for Credit Institutions. The Board of Directors' Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for the Board of Directors approval and endorsement. The external auditors review the half year consolidated interim financial statements and audit the consolidated annual financial statements.

The consolidated financial statements are published annually and consolidated interim financial statements on quarterly basis. As is provided for in the Financial Undertakings Act and the Bank's Articles of Association, the Bank's external audit firm is elected at the Annual General Meeting.

Corporate Governance

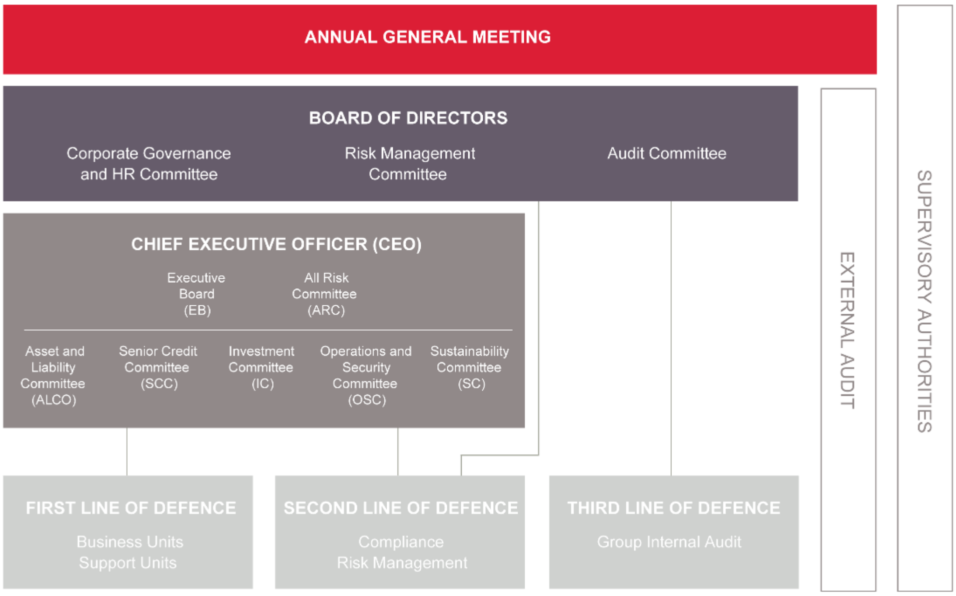
Pursuant to the Financial Undertakings Act, the Bank is obligated to comply with recognised guidelines on good corporate governance.

The Bank's governance practises are consistent with general corporate governance guidelines for entities regulated by official supervisors and regulatory instruments. The regulatory framework for corporate governance practices within the Bank consists of the law applicable to entities subject to the supervision of the FSA as well as other applicable law and regulations, including those imposed by the FSA and Nasdaq Iceland. The applicable law includes, *inter alia*, the Financial Undertakings Act, the Securities Transactions Act, the Disclosure Requirements Act, the Competition Act and the Public Limited Companies Act, which along with the Bank's Articles of Association lay the foundation for the Bank's existence and activities.

The Board of Directors follow the Corporate Governance Guidelines, in accordance with Paragraph 7 of Article 54 of the Financial Undertakings Act. The Bank is in full compliance with the Corporate Governance Guidelines.

On 2 February 2021, Updated Corporate Governance Guidelines were published. The guidelines will not enter into force and replace the previous version of the Corporate Governance Guidelines until 1 July 2021, allowing companies a transition period to incorporate the updated guidelines into their governance practice and procedures. The Bank's internal governance is in full compliance with the Updated Corporate Governance Guidelines.

The Bank was first recognised as "Exemplary in Corporate Governance" in March 2014. The recognition was awarded following a comprehensive review of the practices of the Board of Directors, the Board of Directors subcommittees and management. The recognition has been renewed annually since then. The recognition was first granted by the Centre of Corporate Governance at the University of Iceland up until 2019 and thereafter by Stjórnvísi, an Icelandic business association focused on corporate governance best practices.



General Meetings

The supreme authority in the affairs of the Bank rests with the shareholders. Shareholders' meeting shall be convened with at least three weeks' notice and no more than four weeks' notice. Shareholders' meeting shall be convened by an advertisement in one or more reliable media and by electronic means, such as by e-mail or by publication on the Bank's website.

In addition to shareholders and their proxies, the auditor, directors and the CEO of the Bank have the right to attend shareholders' meetings. They shall have unrestricted rights to speak and submit motions at the meeting. Members of the Board's sub-committees and Nomination Committee, together with the Board candidates, shall also be allowed to attend shareholders' meetings and have the right to speak. The Board of Directors may also invite experts to attend individual shareholders' meetings and the Bank's employees.

The Annual General Meeting of the Company is held before the end of the month of April each year. The agenda of the Annual General Meeting of the Bank shall include the following items of business: (1) The report of the Board of Directors on the Company's operation and activities for the preceding year of operation; (2) Approval of the Company's annual financial statements and consolidated financial statements for the preceding year; (3) Decision as to how the Company's profit or loss during the preceding year of operation shall be handled; (4) Election of the Company's Board of Directors and alternate directors and the appointment of the Chairman of the Board; (5) Election of an audit firm; (6) Decision on the remuneration to the Board of Directors and compensation to the members of the Board's sub-committees; (7) Approval of the Company's remuneration policy; (8) Approval of the Company's Nomination Committees' rules of procedure; and (9) any other matters.

Internal Control, Risk Management, Auditing and Accounting

Internal Control

The risk management and internal control framework of the Bank is based on the three-lines-of-defence model, as referred to in the European Banking Authority's Guidelines on Internal Governance and aims for informed decision-making and strong risk awareness throughout the Bank. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Bank's internal rules. The first line of defence consists of the Bank's business and support divisions; the second line of defence is comprised of the Bank's internal control divisions, risk management and compliance; and the third line of defence is group internal audit which keeps the Board of Directors and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Risk Management

The Board of Directors approves the risk policy, risk appetite statement and procedure for risk management and ensures that internal procedures for risk management are revised at least annually. The All Risk Committee, a Senior Management Committee, is comprised of the Chief Executive Officer, all the managing directors of the Bank and other members of management appointed by the Chief Executive Officer. The committee is responsible for the review and implementation of the risk management and internal control policies issued by the Board of Directors and monitors the risk profile of the Bank is within the limits of the risk appetite statement of the Board of Directors. The All Risk Committee issues guidelines for risk assessment and individual risk thresholds or limits in accordance with Board approved risk appetite.

Audit and accounting

The Chief Executive Officer ensures that the Board of Directors are provided with accurate information on the Bank's finances, development and operations on a regular basis. The Board Audit Committee assists the Board of Directors in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control and the audit process. The Bank's finance division is responsible for the preparation of the Group's consolidated financial statements in line with IFRS as adopted by the European Union and additional requirements in the Annual Accounts Act, the Financial Undertakings Act and Rules No. 532/2003 on Accounting for Credit Institutions. The Board Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for the Board of Directors approval and endorsement. The external auditors review the half year consolidated interim financial statements and audit the annual consolidated financial statements.

The consolidated financial statements are published annually and consolidated interim financial statements on quarterly basis. As is provided for in the Financial Undertakings Act and the Bank's Articles of Association, the Bank's external audit firm is elected at the Annual General Meeting. In accordance with Article 4 of Act No. 46/2016 on the Auditor General and auditing of central government accounts, external auditing of public limited companies in which the Icelandic state is the majority owner is the responsibility of the Auditor General. Furthermore, the provisions of the Act allow the Auditor General to contract external auditors, audit firms and other specialists to work on his/her behalf on individual tasks that INAO is responsible for. Under its previous ownership, the Bank selected Ernst & Young ehf. as its external auditors based on a selection process run by the Audit Committee. Following the Icelandic state's acquiring of all shares in the Bank, Ernst & Young has carried on their duties as external auditors based on arrangements with INAO. Upon expiry, the agreement was extended for an additional two years, the current fiscal year being the latter of the two years.

The current members of the Board Audit Committee are Anna Þórðardóttir, Frosti Ólafsson and Hallgrímur Snorrason.

Group Internal Audit

The Chief Audit Executive is appointed by the Board of Directors, reports directly to the Board of Directors and directs the Group's Internal Audit with a mandate from the Board of Directors. Group Internal Audit operates independently from other departments in accordance with Article 16 of the Financial Undertakings Act. The department provides the Board of Directors with independent and objective assurance over the effectiveness of risk management, control and governance processes. The Chief Audit Executive is engaged by the Board of Directors and is responsible for internal audit on a group basis.

Compliance

The Bank's compliance function is set up in accordance with the Supervision Guidelines on the status and responsibilities of the compliance function of financial undertakings, No. 5/2011 published by the FSA.

The Bank's Compliance Officer is hired by the Chief Executive Officer, subject to the Board of Directors confirmation, conferring the department's mandate. The compliance officer maintains an independent position within the Bank's organisation and is responsible for monitoring and assessing regularly whether the Bank's operations regarding securities transactions are in compliance with applicable law. The compliance officer is responsible for assessing and monitoring the Bank's compliance with the AML Act and the Bank's responsible officer under the FATCA and the OECD Common Reporting Standard.

The Bank's compliance function uses a risk-based approach in its practice and assesses relevant risk factors in the Bank's activities subject to the function's supervision, in accordance with its role of supervision. The compliance officer has a threefold role:

- Compliance Officer of a financial undertaking licensed to conclude securities transactions;
- Compliance Officer of an issuer of listed financial instruments; and
- Reporting Officer on Actions to Combat Money Laundering and Terrorist Financing (MLRO).

The compliance officer shall:

- carry out ongoing and specific supervision as to whether the Bank complies with laws and rules in providing services to clients in the area of securities trading;
- carry out ongoing and specific supervision as to whether the Bank and its relevant employees comply with laws and rules which apply to issuers of financial instruments regarding the information disclosure of the bank, treatment of inside information and insider trading; and
- carry out ongoing and specific supervision as to whether the Bank complies with laws and rules regarding actions to combat money laundering and terrorist financing concerning its clients.

Should an examination and/or assessment by the compliance officer reveal shortcomings in fulfilling the above-mentioned laws and rules, the compliance officer shall send comments, demand rectification and inform appropriate parties within the Bank, the Board of Directors and/or appropriate authorities in accordance with its mandate of duties approved by the Board of Directors.

The compliance officer reports to the Board of Directors twice a year on compliance issues or more often if deemed necessary. The report includes information on regarding the Bank's independence, finances, employees, authorities, and remedies. It also accounts for risk factors which are considered to arise from activities concerning securities transactions, issuance of listed financial instruments and actions to combat money laundering and terrorist financing.

The compliance officer informs the CEO, biweekly, or more often if deemed necessary, on compliance issues.

The Chief Audit Executive of the Bank monitors the work of compliance.

Customers' Ombudsman

The Customers' Ombudsman reports to the Bank's General Counsel. The role of the Customers' Ombudsman is to ensure that the business of customers is handled fairly and objectively, prevent discrimination against customers and make certain that the process for handling cases is transparent and documented. The Customers' Ombudsman examined 87 cases in 2020, compared with 77 cases in 2019 and 93 cases in 2018.

Code of Conduct and Sustainability

In 2019 the Bank's strategy was revised and the employees of the Bank played a key role in its formulation. In October 2019 the Board of Directors approved a code of conduct for the Bank's employees. The aim of the code is to promote good operational practices. The Bank seeks to work in harmony with the communities in which it operates and strives to have a positive impact on society. This participation in community programmes rests on the Bank's sustainability policy which is set out by the Board of Directors. The strategy covers five key areas: business, education, environment, workplace, and community. In addition, the Bank has decided to focus particularly on four of the UN Sustainable Development Goals during the course of its business: quality education; gender equality; industry innovation and infrastructure; and climate action. The Bank publishes an Annual and Sustainability Report in accordance with the Nasdaq ESG guidelines, the UN Global Compact, and the SDGs. Since 2009 the Bank has been a signatory to the UN Global Compact on social responsibility. The compact is a guide for companies on how to be socially responsible in practice. The Bank has approved a sustainability policy which is focused on making its operations exemplary in the Iceland business environment based on established international ESG criteria. The aim of the Bank's Sustainability Policy is to embed the Policy's principles and practices into the day to day operations of the Bank and to foster a culture of sustainability that will have a positive impact on society. The Bank's sustainability objectives through 2025 have been approved by the Board of Directors.

The Bank aspires to be a leader in sustainable development and to move Iceland forward by empowering its customers to succeed.

Service Agreements, Remuneration and Entitlements of Members of the Board of Directors and Executive Committee

Compensation Committee

Overview

The Bank's Corporate Governance and Human Resources Committee serves as the Bank's Compensation Committee. As stated above, the committee is responsible for providing oversight regarding compensation and human resource issues. The Bank's compensation policy states that the compensation committee of the Bank shall be comprised of three Directors of the Board. The role of the compensation committee shall be to guide the Board of Directors and CEO in deciding on the terms of employment of senior management. The committee shall ensure that the terms of employment of the Bank's executives are within the framework provided by the compensation policy and report on its implementation yearly in connection with the Bank's Annual General Meeting and in the Board of Directors' annual financial statements. Moreover, the committee shall monitor the developments of collective bargaining agreements, trends in salary expenses and number of employees. The Board of Directors has approved a mandate of appointment for the committee defining its role and responsibilities which shall be published on the Bank's website.

The Bank's compensation policy was adopted at the Bank's Annual General Meeting on 18 March 2021 pursuant to Article 79(a) of the Public Limited Companies Act. The policy is reviewed annually and submitted to the Annual General Meeting for approval or rejection. Currently, the policy restricts bonus payments and if the Bank intends to set up a bonus payment system, the approval of the Bank's shareholders meeting is required as stipulated according to the rules.

Further, Article 57(a) of the Financial Undertakings Act states that a financial undertaking is permitted to offer stock options or bonus payments in accordance with rules established by the FSA. The financial undertaking in question must take into account the total financial results of the financial undertaking over the longer term, underlying risk and cost of capital. The total bonus payments provided to employees (including postponed payment) cannot constitute a higher amount than 25% of the yearly salary of the employee in question minus the bonus payments. According to paragraph 2 of Article 57(a), it is however not permissible to grant bonus payments to directors or employees working in risk management, internal auditing or compliance. Paragraph 3 further states that the earned entitlements of employees under a wage bonus system shall be charged to the accounts each year to the extent that accounting rules will permit, and they shall be specifically accounted for in the notes to the annual financial report. Violations of these rules are subject to administrative fines and possible imprisonment as stipulated in item 34 of paragraph 1 of Article 110 and item 20 of Article 112. Administrative Rules No. 388/2016 on Bonus Schemes have been established by the FSA. These rules further stipulate the regulatory environment concerning bonus payments of financial undertakings such as general rules, objective of bonus payments, the set-up of a bonus payment scheme, cancellation of bonus payments and disclosure requirements.

Board of Directors

The table below sets forth the remuneration paid to members of the Board of Directors for the year ended 31 December 2020.

Name	Fixed remuneration	Additional remuneration	Total
Hallgrímur Snorrason, Chairman of the Board	ISK 10.5 million	-	ISK 10.5 million
Heiðrún Jónsdóttir, Vice-Chairman of the Board	ISK 8.9 million	-	ISK 8.9 million
Anna Þórðardóttir, member of the Board	ISK 7.9 million	-	ISK 7.9 million
Árni Stefánsson, member of the Board	ISK 7.9 million	-	ISK 7.9 million
Frosti Ólafsson, member of the Board	ISK 5.9 million	-	ISK 5.9 million
Guðrún Þorgeirsdóttir, member of the Board	ISK 5.9 million	-	ISK 5.9 million
Herdís Gunnarsdótir, alternate member of the Board	ISK 0.4 million	-	ISK 0.4 million
Friðrik Sophusson, former Chairman of the Board	ISK 2.5 million	-	ISK 2.5 million
Tómas Már Sigurðsson, former Vice-Chairman of the Board	ISK 2.0 million	-	ISK 2.0 million
Auður Finnbogadóttir, former member of the Board	ISK 1.7 million	-	ISK 1.7 million
Flóki Halldórsson, former member of the Board	ISK 4.7 million	-	ISK 4.7 million

Executive Committee

The table below sets forth the remuneration paid to members of the Executive Committee for the year ended 31 December 2020.

Name	Total salaries	Contributions to pension funds
Birna Einarsdóttir	ISK 48.7 million	ISK 11.6 million
Ásmundur Tryggvason	ISK 43.3 million	ISK 6.1 million
Guðmundur Kristinn Birgisson	ISK 36.5 million	ISK 5.2 million
Jón Guðni Ómarsson	ISK 42.0 million	ISK 5.9 million
Riaan Dreyer	ISK 37.7 million	ISK 5.6 million
Sigríður Hrefna Hrafnkelsdóttir	ISK 37.7 million	ISK 5.3 million
Una Steinsdóttir*	ISK 50.8 million	ISK 7.4 million

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* The salary for Una Steinsdóttir includes a one-off employment anniversary payment for 30 years of service. The payment is in accordance with the collective agreement of the Confederation of Icelandic Bank and Finance Employees (SSF).

Service Agreements

Board of Directors

Pursuant to article 4 of the Bank's compensation policy the Bank may not conclude severance agreements with members of the Board of Directors.

SELLING SHAREHOLDER

Shareholder

As at the date of this Prospectus, the Icelandic state, through the Selling Shareholder and Eignarhlutir ehf., owns 100 per cent. of the Bank's share capital (2,000,000,000 Shares of ISK 5 in nominal value). The Bank is not directly or indirectly owned or controlled by parties other than the Icelandic state, through the Selling Shareholder and Eignarhlutir ehf. The business address of the Selling Shareholder is Borgartún 3, 105 Reykjavík, Iceland, and its legal entity identifier (LEI) is 6488047M1L91ULCEC736.

After completion of the Offering, the Selling Shareholder will continue to hold 71.5% of the issued Shares, assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares.

The table below sets forth certain information with respect to the ownership of the Shares immediately prior to the Offering on an actual basis and immediately after the Offering (i) as adjusted for the Offering assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and (ii) as adjusted for the Offering assuming that the Over-Allotment Option is exercised in full and that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares:

Shareholder	Actual		As adjusted for the Offering if the Over-Allotment Option is not exercised		As adjusted for the Offering if the Over-Allotment Option is exercised in full	
	Number	%	Number	%	Number	%
Selling Shareholder	1,998,000,000	99.9%	1,429,818,185	71.5%	1,373,000,003	68.7%
Eignarhlutir ehf.	2,000,000	0.1%	2,000,000	0.1%	2,000,000	0.1%
New shareholders	—	—	568,181,815	28.4%	624,999,997	31.2%
Total.................................	**2,000,000,000**	**100%**	**2,000,000,000**	**100%**	**2,000,000,000**	**100%**

The Selling Shareholder has granted the Over-Allotment Option to the Managers, exercisable, in whole or in part, for 30 days following the first day of trading in the Offer Shares on Nasdaq Iceland to purchase up to 63,636,363 Over-Allotment Shares from the Selling Shareholder, comprising up to 10% of the Existing Offer Shares sold in the Offering, to cover over-allotments, if any, in connection with the Offering. For additional information on the Over-Allotment Option and stabilisation, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

Lock-Up

After completion of the Offering, the Selling Shareholder will continue to hold 71.5% of the Shares (assuming that the Over-Allotment Option is not exercised and that the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares). Other than with respect to the Offer Shares that the Selling Shareholder will sell in the Offering, the Selling Shareholder will agree with the Managers not to divest its remaining Shares for a period of 180 days after the first day of trading in the Offer Shares on Nasdaq Iceland, subject to certain exceptions. See "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

Relationship Agreement

The Selling Shareholder and the Bank have entered into an agreement with reference to Act No. 88/2009 on Icelandic State Financial Investments. The agreement will take effect immediately after the Shares have been listed and an earlier agreement between the Selling Shareholder and the Bank will lapse at the same time. This agreement shall expire once ISFI holds less than one-third of the bank's outstanding shares. The parties to the agreement shall disclose it publicly on their respective websites. The agreement concerns the relationship between the Selling Shareholders and the Bank onwards and covers topics such as, how the Government's Ownership Policy affects the Bank, how the Bank shall be operated, and how communication between the Selling Shareholder and the Bank shall be conducted.

The relationship agreement is divided into four sections, including sections on objectives, information and disclosure, governance and a concluding section containing other provisions such as relating to the agreement's effective date and when it will expire. The first section makes reference to the Government's Ownership Policy, how the Bank shall be mindful of it in its operation and shall inform the Board of Directors of its content. It furthermore notes how the Bank shall be operated in accordance with normal and sound business practices applicable in the financial markets at each time and shall establish financial targets. The targets shall include targets on return on equity, cost ratio, dividend and buyback policy and capital ratio. The first section also includes provisions on how the Bank shall promote competition in the financial market and how it shall ensure its independence from other banks under the ownership of the government. All communications between the Bank and the government as shareholder will only be through the Selling Shareholder. The Selling Shareholder will at each time nominate appropriate number of people for election to the Board of Directors with the individuals nominated by the Selling Shareholder being independent from the Bank and large shareholders of the Bank and fulfil requirements on competency and qualification. According to the concluding provision of the first section, the Bank shall establish a policy concerning sale of assets and make it public and accessible to all.

Information and disclosure is the subject matter of the second section. The agreement emphasises that the Bank shall ensure equality of shareholders in terms of provision of information. The Bank shall provide access to information that the Selling Shareholder requires to conduct its affairs in accordance with its monitoring role and it has a right to under applicable legislation. The Bank may furthermore, to the extent permitted by law, inform the Selling Shareholder of updates and significant measures within the Bank's operation with reasonable notice. The Selling Shareholder shall not disclose information the Bank provides to it and is non-public but shall be authorised to share such information with the Minister and his ministry, provided that such parties are bound by same confidentiality obligations.

The section on governance provides information on how the Selling Shareholder will exercise voting rights on behalf of the government at shareholder meetings independent of other shareholders and will nominate members for election to the Board of Directors in proportion to its shareholding in the Bank at the time of each election. The Board of Directors shall be independent and a clear separation of authorizations and responsibilities shall be between the Board of Directors and its management. The Selling Shareholder shall conduct further sell-downs of shares in the Bank in accordance with the provisions of the Government's Ownership Policy and standard practices in equity markets. The Selling Shareholder is, at any time after the lock-up period, entitled to sell any number of shares in the Bank but will use reasonable efforts to conduct any sell down in an orderly market manner.

SHARES AND SHARE CAPITAL

Share Capital Information

As at 31 March 2021, the authorised share capital of the Bank was ISK 10,000,000,000 represented by 10,000,000,000 Shares, each of the same class with a par value of ISK 1.00. At a shareholder meeting 26 May 2021, the Articles of Association of the Bank were amended such that the share capital is represented by 2,000,000,000 Shares each in the same class with par value of ISK 5.00. Otherwise, there has been no changes to the share capital of the Bank since 1 January 2018.

The Shares have been issued in accordance with Icelandic law, have been fully paid and are denominated in ISK. The rights associated with the Shares, including those set out in the Articles of Association of the Bank, can only be changed in accordance with the procedures set forth in the Public Limited Companies Act requiring the approval of a minimum of two-thirds of the votes cast and also the approval of shareholders controlling at least two-thirds of the share capital in respect of which votes are represented at the shareholders' meeting.

The Shares are denominated in ISK. The Shares are electronically registered in book-entry form under the name of the relevant shareholder or nominee pursuant to Article 12 of the Securities Transactions Act with Nasdaq CSD Iceland in accordance with Act No. 7/2020 on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments and any subsequent rules based thereon. The Shares will be traded in ISK on Nasdaq Iceland under the ISIN code IS0000028538.

Application has been made to list and admit all of the Shares to trading under the symbol "ISB" on Nasdaq Iceland.

Certain Rights Attached to the Shares

General Meetings and Voting Rights

The Annual General Meetings are held before the end of April each year. The supreme authority in the affairs of the Bank is in the hands of legitimate shareholder meetings. One vote is attached to each Icelandic Króna of share capital, and decisions at shareholder meetings are generally taken by majority vote.

Preferential Rights

No special rights are attached to the Shares of the Bank.

Pre-Emptive Rights and Increases of Share Capital

An increase in the share capital of the Bank may be authorised at a meeting of shareholders. Shareholders have pre-emptive rights to an increase in the Bank's share capital in proportion to their holdings of the Shares and within the time limits specified in the resolution to increase the share capital. However, a meeting of shareholders can, by a two-thirds majority vote, waive pre-emptive rights to increases of share capital, provided that there is no discrimination.

Action Required to Change the Rights of Shareholders

Each shareholder is under the obligation, without the necessity of any specific undertaking, to abide by the Bank's Articles of Association in their current form or as amended from time to time. Shareholders' liability for the Bank's affairs is limited to the share contribution of each shareholder. According to article 7.1 of the Articles of Association, they may be amended on a lawfully convened shareholders' meeting. Any proposals for amendments of the Bank's Articles of Association are required to be included in the meeting announcement. A decision to amend the Bank's Articles of Association requires the approval of two-thirds of the votes cast provided that the shareholders, controlling at least two-thirds of the total share capital, represented in the meeting participate in the vote, cf. Article 93 of the Public Limited Companies Act. According to article 94 of the Public Limited Companies Act amendments to the Articles to Association that compromise the shareholders' right to dividends, increase obligations and limit transfer of shares require consent of all shareholders.

Repurchases of the Shares

Pursuant to Icelandic law, the Bank may only repurchase the Shares within certain limits and in compliance with the following requirements:

- the repurchase of the Shares is required to be pursuant to authority granted to the Board of Directors at a meeting of shareholders, with the resolution granting such authorisation specifying the maximum number of the Shares that may be repurchased, the minimum and maximum price which may be paid for the Shares. A company whose shares are admitted to trading on a regulated securities market or multilateral trading facility is, however, not permitted to repurchase own shares at a higher price than the price in the last independent transaction or the highest existing independent offer in the trading systems where the transactions are carried out, whichever is higher. Such purchases are permitted, however, if made by a market maker;
- the duration of the authorisation to repurchase Shares cannot exceed five years;
- the aggregate nominal value of the Shares repurchased, together with the aggregate nominal value of the Shares already held by the Bank and its subsidiaries, may not exceed 10% of the Bank's share capital;
- the Bank can only repurchase the Shares to the extent that its capital and reserves (equity) exceed its non-distributable reserves and, after deducting repurchased Shares, its share capital must amount to a minimum of EUR 5 million;
- the Shares repurchased are required to be fully paid; and
- prior approval from the FSA has been obtained pursuant to Article 84(3) of the Financial Undertakings Act.

Rights to Dividend and Liquidation Proceeds

Payment of dividends is proposed by the Board of Directors and must be approved by the shareholders at a general meeting (whether an annual general meeting or an extraordinary general meeting). Dividends must be paid no later than six months after the date of the general meeting at which such dividends were approved. Any dividends declared are payable to the shareholders of record at the time of the payment of dividends. However, the general meeting may decide that the dividends will be payable to the shareholders of record on a different date, *provided that* the alternative date is stipulated in the general meeting's resolution on dividend payment and is notified to the market via Nasdaq Iceland.

Dividends on the Shares will not be cumulative. Accordingly, if for any reason our Board of Directors does not declare a dividend on the Shares for a period prior to the related dividend payment date, that dividend will not accrue, and we will have no obligation to pay a dividend for that dividend period on the applicable dividend payment date or at any time in the future.

There are no provisions in the Bank's Articles of Association regarding the expiration of the right to dividends that have not been collected. As a result, such rights lapse after four years from the date it becomes payable according to Act No. 15/2007 on the Limitation Periods for Claims and reverts to the Bank if not claimed within that period of time.

The date for the payment of dividends is decided by the shareholders at the general meeting. Dividends are declared at the general meeting and paid in Icelandic Króna. The Bank withholds Icelandic tax on dividends depending on the shareholder receiving the dividends.

Upon liquidation of the Bank, shareholders would be entitled to receive proportionately any assets remaining after the payment of the Bank's debt and taxes and the expenses of the liquidation.

Share Capital Development

The Bank has not issued any Shares in the years ended 31 December 2020, 2019 and 2018.

Dividends and Dividend Policy

Dividend Policy

Based on the then-applicable regulatory requirements, the Bank is targeting to pay out approximately 50% of earnings as a base dividend. The Bank will focus on excess capital to support further dividend payments, buybacks and/or ROE enhancing growth.

Special distributions and dividend capacity

The Bank anticipates additional capital return to approach capital targets over the medium term. However, the speed and quantum of such special distributions, for example, in the form of a share buyback or extraordinary dividend, would depend on a number of factors, including (but not limited to) management of foreign exchange imbalances, the Bank's liquidity position, access to capital markets, the capital requirements set by the FSA, recommendations from the European Banking Authority ("**EBA**") and more. Such returns would likely take place over a number of years.

The Bank is currently subject to restrictions in distributing dividends and repurchasing shares due to the COVID-19 pandemic. Such distribution may not exceed 25% of accumulated profit in 2019 and 2020 or 0.4% decrease in Tier 1 capital, whichever is lower. This restriction applies until 30 September 2021 and is based on recommendations from EBA. It is uncertain whether and how any such restrictions will be extended.

In the Minister's Decision, the Ministry of Finance further requested that the Selling Shareholder assess whether it would be in furtherance of the objectives of the Government's Ownership Policy concerning the maximisation of financial benefits of ownership and sale of shares, if the Bank paid dividends higher than ISK 3 to 4 billion prior to the Offering, and if not in furtherance of such objective, the Selling Shareholder was requested to provide adequate supporting arguments. As requested by the Selling Shareholder, the Board of Directors of the Bank provided its opinion on whether it would be feasible and serve the interest of the Bank to distribute equity to the Selling Shareholder prior to the Offering. In its opinion, the Board of Directors indicated that it would be reasonable to postpone all additional equity distribution until the uncertainty resulting from the COVID-19 pandemic has been reduced.

The Board of Directors formulated the dividend policy as outlined above in connection with the Offering and in order to promote the success of the Offering, and accordingly considered that adopting the dividend policy was in the best interests of the Bank.

Dividends Paid

The table below sets forth the amount of dividends paid by the Bank for 2020, 2019 and 2018. The Bank did not pay any dividend in 2020 as a result of the COVID-19 pandemic; however, the dividend of ISK 3.4 billion (ISK 0.34 per Share) accrued in respect of 2020 was paid in the first quarter of 2021.

	Year ended 31 December				
	2020	**2019**	**2018**	**2017**	**2016**
			(*ISK in millions*)		
Dividends paid.......	—	5,300	13,000	10,000	37,000
Dividends paid per Share..................	—	0.53	1.30	1.00	3.70

Other than for 2020 for the reason noted above, since 2016, the Bank has delivered a consistent 50% ordinary dividend pay-out ratio. In addition, this was combined with further excess capital distributions in 2016 and 2018 of ISK 27 billion and ISK 6 billion, respectively.

Legal and Regulatory Requirements

The Public Limited Companies Act provides that it is only permissible to allocate as dividend profit in accordance with approved annual accounts for the immediately preceding fiscal year profit brought forward from previous years and disposable earnings after deducting any losses which have not been met and any moneys which according to Icelandic laws and the Bank's Articles of Association shall be contributed to a reserve fund or for other use.

The Public Limited Companies Act further provides that a shareholders' meeting will decide upon the allocation of dividends after a company's board of directors has submitted proposals in that respect. The Public Limited Companies Act prohibits allocation of more dividends than the board of directors proposes or approves. Shareholders holding a total of at least 10.0% of the share capital may at an annual general meeting, *provided that* the company's board of directors be advised thereof, require an annual general meeting to decide upon the allocation of a sum as dividends amounting to at least 25.0% of the remainder of annual profits after any losses of previous years have been met and any amounts to be contributed to a reserve fund in accordance with Icelandic laws or the Bank's Articles of Association, or which cannot be allocated as dividends for other reasons, have been deducted. It is, however, not permissible to require allocation of more than the equivalent of 2.0% of the Bank's capital and reserves (equity).

The date of maturity of dividends shall be no later than six months after a decision relating to the allocation thereof has been made.

The Bank will follow Nasdaq Iceland's proposals on dividend payments, which is that trading in the Shares exclusive of dividends begins the business day immediately following the day the dividend proposal is approved and that payment of dividends will be made no later than 30 days after the record date. With the exception of dividend payments, shareholders are not entitled to any of the Bank's profits.

Restrictions on Ownership and Transfer of the Shares

The Bank's Articles of Association do not contain any limitations on the ability to transfer the Shares, and shareholders may pledge the Shares unless otherwise prohibited by law. Pre-emptive rights to increases in the share capital are transferable according to the Public Limited Companies Act.

However, special rules apply to qualifying holdings in financial institutions pursuant to Articles 40-49.b. of the Financial Undertakings Act. Parties who propose to acquire a qualifying holding in a financial institution must seek in advance the approval of the FSA. In addition, the approval of the FSA is required when a party, alone or jointly with others, intends to increase its holding to such an extent that the direct or indirect ownership in the share capital, guarantee capital or voting rights reaches or exceeds 20.0%, 33.0% or 50.0% or comprises such a large portion that the financial institution may be regarded as its subsidiary company. A "qualifying holding" is a direct or indirect holding in a financial undertaking which represents 10.0% or more of its share capital, guarantee capital or voting rights or any other holding which enables the exercise of a significant influence on the management of the financial institution. If the owner of a "qualifying holding" intends to reduce its shareholding with the result that such owner will not subsequently own a "qualifying holding", this is required to be reported to the FSA in advance together with the shareholding following the reduction. If the shareholding decreases below the specified levels (i.e., 20.0%, 33.0% or 50.0%) or to such an extent that the financial institution ceases to be a subsidiary of the parent company in question, this is also required to be reported.

As a general rule, a person acquiring the Shares cannot exercise its rights as a shareholder until such person's name has been registered in the Bank's share registry or such person has announced and proven the ownership of the Shares. The electronic registration of securities is governed by the Central Securities Depositories Act.

A printout from Nasdaq CSD Iceland on the ownership of the Shares is considered a valid registration of the Shares. The Bank considers the share registry as full proof of ownership of the Shares and the rights attached to them. Dividends and all announcements to shareholders are sent to the parties registered in the Bank's share registry as owner of the Shares. The Bank has no liability if payments or announcements do not reach their recipients because a notification of change of address has not been delivered.

Rights to the Shares in electronic form must be registered with Nasdaq CSD Iceland. Share certificates may not be issued or endorsed for registered rights to the Shares in electronic form, and any such attempted transactions are void. Registration of the ownership of the Shares in electronic form with Nasdaq CSD Iceland, subsequent to Nasdaq CSD Iceland's final entry, formally gives a registered owner legal authorisation to the rights to which they are registered. Priority of incompatible rights is determined by the time stamp when a request from the Bank's data central on the registration reaches Nasdaq CSD Iceland.

ARTICLES OF ASSOCIATION

The following is an English translation of the Articles of Association of the Bank, approved at the extraordinary general meeting of the Bank on 26 May 2021:

1 NAME, ADDRESS AND PURPOSE OF THE COMPANY

1.1 The Company is a public limited company.

1.2 The name of the Company is Íslandsbanki hf.

1.3 The domicile of the Company and legal venues are in Kópavogur.

1.4 The Company is a financial undertaking. The purpose of the Company is to operate a commercial bank and provide financial services. The Company may engage in any activities commercial banks may carry out pursuant to applicable laws and the Company's operating licenses, and any other activity normally related to such activities. The Company may engage in activities that are consistent with its operations and may take an ownership interest in other companies for such purpose.

2 SHARE CAPITAL OF THE COMPANY

2.1 The share capital of the Company amounts to ISK 10,000,000,000 – ten billion Icelandic Krónur. The share capital is divided into 2,000,000,000 shares of five króna in nominal value, or multiples thereof. All of the Company's share capital is on a single class.

2.2 The Company's share capital may be increased by a resolution of a shareholders' meeting either through subscription for new shares or by issuance of bonus shares, such resolution requiring the same number of votes as required for the amendment of these Articles of Association. If the Board of Directors is granted the authority to issue new shares the decision of the shareholders' meeting shall be recorded in a special Annex to these Articles of Association and such Annex shall be an integral part of the Articles during term of such authorisation.

2.3 Shareholders shall have pre-emptive rights to new shares in direct proportion to their shareholding. Should a shareholder not exercise its priority rights to new shares the entitlement of other shareholders shall be increased proportionally. Pre-emptive rights may be waived according to Article 34(3) of Act No. 2/1995, on Public Limited Companies.

2.4 Only a shareholders' meeting can resolve on the reduction of share capital, such resolution requiring the same number of votes as required for the amendments of these Articles of Association.

2.5 The Company may not grant loans or other credit against security in the form of shares issued by the Company itself.

2.6 The Company may purchase and hold its own shares to the extent authorised by law. If authorisation to purchase and hold own shares is granted by a shareholders' meeting this must be recorded in a special Annex to these Articles of Association and such Annex shall be an integral part of the Articles during term of such authorisation.

2.7 The Company's shares are electronically registered in a securities depository as provided for by Act No. 7/2020, on Securities Depositories, Settlement and Electronic Registration of Title to Financial Instruments. A statement from the securities depository concerning title to shares in the Company constitutes a valid share register and a valid proof of title to shares in the Company. Any notices to the shareholders and allocation of rights, such as dividends, shall be addressed or allotted to the party recorded in the Company's register of shares as the owner of the respective shares.

2.8 No restrictions are placed on transactions with shares in the Company. Transactions with qualifying holdings are subject to the limitations of the Act No. 161/2002, on Financial Undertakings. Shares in the Company may be transferred or pledged unless otherwise provided for by law. Registration of lien rights and changes in ownership and their implementation are subject to Act No. 7/2020, on Securities Depositories, Settlement and Electronic Registration of Title to Financial Instruments.

2.9 Each shareholder is obligated to abide by these Articles of Association as they are at any given time. Shareholders bear no responsibility for the Company's obligations beyond their holding in the Company unless they assume such obligations through a specific legal instrument. This Articles cannot be amended unless unanimously approved by all shareholders.

2.10 No special rights are attached to the shares in the Company. Shareholders shall not be subject to redemption of their shares unless otherwise provided for by law.

3 SHAREHOLDERS' MEETINGS

3.1 The supreme authority in the affairs of the Company is in the hands of lawful shareholders' meetings pursuant to statutory law and these Articles of Association. All shareholders are entitled to attend a shareholders' meeting, to address the meeting and exercise their voting rights.

3.2 The Annual General Meeting of the Company shall be held before the end of the month of April each year.

3.3 The following items shall be on the agenda of the Annual General Meeting:

(i) The report of the Board of Directors on the Company's operation and activities for the preceding year of operation;

(ii) Approval of the Company's annual financial statements and consolidated financial statements for the preceding year of operation;

(iii) Decision as to how the Company's profit or loss during the preceding year of operation shall be handled;

(iv) Election of the Company's Board of Directors, alternate directors and the Chairman of the Board;

(v) Election of an auditor;

(vi) Decision on the remuneration to the Board of Directors and compensation to the members of the Board's sub-committees;

(vii) Approval of the Company's remuneration policy;

(viii) Approval of the Company's Nomination Committee's rules of procedure;

(ix) Other matters.

3.4 If so requested in writing at an Annual General Meeting by shareholders controlling at least one-third of share capital, a decision on items ii) and iii) of Article 3.3 shall be postponed to a follow-up Annual General Meeting, to be held no sooner than one month and no later than two months after the Annual General Meeting. A further postponement cannot be requested.

3.5 A shareholder meeting shall be convened by the Board of Directors when the Board deems it necessary or at the request of the Company's auditor or shareholders, controlling at least 1/20 of the Company's share capital, submitted in writing and stating the business of the meeting. Upon receipt of a valid meeting request the Board of Directors shall convene a meeting within fourteen days.

3.6 A shareholders' meeting shall be convened with at least three (3) weeks' notice and no more than four (4) weeks' notice. Shareholders' meeting shall be convened by an advertisement in one or more reliable media and by electronic means, such as by e-mail or by publication on the Company's website. A follow-up shareholders' meeting shall be convened in the same manner and with the same notice as other shareholders' meetings.

3.7 Three weeks prior to the shareholders' meeting and on the day of the meeting the following information shall be accessible to the shareholders on the Company's website: (i) the meeting announcement, (ii) the total number of shares and votes as of the date the meeting was announced, (iii) documents to be presented to the shareholders' meeting, (iv) motions of the Company's Board of Directors or its committees, as the case may be, and (v) form of power of attorney.

3.8 The Board of Directors may decide to hold a shareholders' meeting by electronic means, either in full or in part, provided the technology to be used for the meeting is determined by the Board of Directors to be secure and fulfils the requirements of the Act No. 2/1995, on Public Limited Companies. A decision to hold a shareholders' meeting by electronic means shall be stated in the meeting announcement. The announcement shall also provide information on the necessary technical equipment which shareholders require to participate in the meeting, information as to how shareholders are to give notice of their participation, information as to how voting will take place and where shareholders can obtain instructions on telecommunications equipment, passwords for access to the meeting and other relevant information. If a shareholders' meeting is held in part or in full by electronic means a password entered in the specified telecommunications equipment shall be equivalent to the signature of the respective shareholder and shall be considered confirmation of his participation in the shareholders' meeting.

3.9 Each shareholder is entitled to have a specific matter submitted to a convened shareholders' meeting, if he makes a written or electronic request for that to the Board of Directors with sufficient notice to allow the matter to be placed on the agenda of the meeting, however, no later than 10 days prior to the meeting. The request must be accompanied by grounds for the same or a draft resolution for the Board of Directors. Information on such request must be published on the Company's website no later than three days prior to the meeting together with the proposal and, as the case may be, the revised meeting agenda.

3.10 Matters which have not been included on the agenda of a shareholders' meeting cannot be resolved at the meeting without the consent of all the Company's shareholders but resolutions thereon may be passed as guidance of the Company's Board of Directors. Supplementary motions or amendments, legally submitted, may be raised at the meeting itself, however, despite not having been available to shareholders beforehand.

3.11 A shareholders' meeting shall be duly constituted, regardless of attendance, if it was lawfully convened and if one or more shareholders attend the meeting. The meeting may be held at a location other than the Company's head office.

3.12 In addition to shareholders and their proxies, the auditor, directors and the CEO of the Company (managing director pursuant to the Act No. 2/1995, on Public Limited Companies and Act No. 161/2002, on Financial Undertakings. They shall have unrestricted rights to speak and submit motions at the meeting. Members of the Board's sub-committees and Nomination Committee, together with the Board candidates, shall also be allowed to attend shareholders' meetings and have the right to speak. The Board of Directors may also invite experts to attend individual shareholders' meetings and the Bank's employees.

3.13 A shareholder may attend a meeting along with his advisor, but such advisor has neither the right to submit proposals nor to vote at shareholders' meetings. A shareholder is, however, authorised to allow his advisor to speak on his behalf. Any proxy attending a shareholders' meeting on behalf of a shareholder shall present a written or electric, and dated, power of attorney. The power of attorney shall be presented no later than at the meeting and shall be deemed valid only for attendance at that shareholders' meeting unless otherwise clearly stated in the power of attorney. A power of attorney may be revoked at any given time.

3.14 A meeting chairman elected by the shareholders' meeting will preside over the meeting. The meeting chairman shall resolve all disputes concerning lawfulness of the meeting in accordance with these Articles of Association and applicable law. The meeting chairman shall further decide on the process of debates, procedures of matters and voting. The meeting chairman appoints a secretary with the meetings' approval. Minutes of meetings shall be recorded in the meeting record book and be considered fully valid proof of what took place at the shareholders' meeting. The minutes shall be read aloud prior to the conclusion of the meeting, if requested by shareholders, and any comments raised concerning them shall be recorded. The minutes shall be signed by the meeting chairman and the secretary.

3.15 At shareholders' meetings, each króna of share capital carries one vote. A simple majority of votes shall determine the outcome at shareholders' meetings, unless otherwise provided for by law or these Articles. Proposals are deemed rejected if they receive equal votes.

4 BOARD OF DIRECTORS

4.1 The Company's Board of Directors shall be comprised of seven (7) individuals and two (2) alternate directors. Statutory provisions shall apply concerning the eligibility of directors. Directors shall be elected at an Annual General Meeting for one year at a time.

4.2 The proportion of each gender among directors and alternate directors shall be at least 40%. The three (3) female candidates and three (3) male candidates who receive the most votes and the person who receives the most votes after the aforementioned candidates in the Board election shall be deemed as the rightfully elected Board members. The female candidate and the male candidate who receive the most votes in the election of alternate members shall be deemed as the rightfully elected alternate members of the Board. Should the aforementioned gender ratio not be reached, the election shall be postponed to a follow-up shareholders' meeting, which shall be convened within one month. Until a legitimate election has taken place, resulting in the required gender representation, the mandate of the previous directors and/or alternates as the case may be is extended.

4.3 Election of the Board of Directors shall be made by majority cumulative voting between individuals, cf. item c of Article 63(6) of the Act No. 2/1995, on Public Limited Companies.

4.4 The Company shall operate a Nomination Committee whose role is to nominate individuals to the Company's Board of Directors at the Company's Annual General Meeting, or as the case may be at a shareholders' meeting where Board elections are on the agenda. The members of the Nomination Committee shall be three (3) and they shall be elected for one year at a time by the Board of Directors. The committee shall be independent in its work and the majority of the committee's members shall be independent of the Company and its management. Those who intend to stand for election to the Nomination Committee shall notify the Board of Directors of their candidacy before 1 September each year. Information on the appointment of the Nomination Committee shall be made available to the shareholders on the Company's website no later than six (6) months prior to the annual general meeting. The rules of procedure of the Nomination Committee shall be approved at a shareholders' meeting.

4.5 Those individuals who intend to stand for election as directors must give notice of their candidacy in writing to the Company's Nomination Committee no later than five days prior to the commencement of the shareholders' meeting at which the election is to take place. ln their notification candidates must provide details including their name, identification number, address, principal employment, other directorships held, education, experience and holding in the Company. Disclosure shall also be made of interest connections with the Company's principal customers and competitors, as well as with shareholders holding more than 10% in the Company. Information on the candidates to the Board of Directors shall be made available to the shareholders at the Company's headquarters and published on the Company's website no later than two days before the shareholders' meeting.

4.6 The Chairman of the Board shall be elected separately at the Annual General Meeting or a shareholders' meeting shall elect a Chairman and Vice Chairman. The Board shall allocate responsibility for other tasks.

4.7 The Company's Board of Directors constitutes the supreme authority in the affairs of the Company between shareholders' meetings. The Board of Directors shall implement rules of procedure where the Board's operations are further detailed.

4.8 The Company's Board of Directors shall hire the Company's CEO, determine the terms of the CEO's employment within the limits set by the remuneration policy adopted by a shareholders' meeting. Similarly the Board of Directors dismisses dismiss the CEO from his position.

4.9 The Chairman of the Board convenes and presides at Board meetings. Meetings shall be held at the discretion of the Chairman. The Chairman shall also convene a meeting of the Board if requested by one, or more, members of the Board or the CEO.

4.10 The CEO attends meetings of the Company's Board of Directors, at which the CEO is entitled to speak and make proposals, unless the Board decides otherwise in individual instances. The Company's auditors shall similarly be entitled to attend Board meetings.

4.11 A Board meeting has a quorum if a majority of directors attend. Major decisions, however, may not be taken without all directors having had the opportunity to discuss the matter if at all possible.

4.12 The signatures of a majority of directors bind the Company. The Board also grants power of procuration for the Company.

4.13 A decision of the Board of Directors is deemed to be approved if approved by majority of the Board members. In the event of a tie, the Chairman shall have the deciding vote. Important decisions may however not be made unless all members of the Board have had the opportunity, if possible, of discussing the matter. Minutes of the Board meeting shall be kept and confirmed by the Board members with their signatures. Directors may participate in meetings with the assistance of electronic media, if necessary.

4.14 In all other respects, the applicable legislation shall provide for the responsibilities, powers and tasks of the Board of Directors.

5 CHIEF EXECUTIVE OFFICER (CEO)

5.1 The Board shall hire the Company's CEO. The CEO has charge of the day-to-day operations of the Company, and in this respect the CEO shall observe the policy and directions of the Board of the Directors. Day-to-day operations do not include measures which are unusual or extraordinary. Such measures may only be made by the CEO pursuant to special authorisation from the Board of Directors of the Company unless it is impossible to wait for the decision of the Board of Directors without causing a serious disadvantage or risk for the Company's operations. In such cases, the CEO shall consult with the Chairman of the Board, as is possible, and the Board shall subsequently be notified of the measure without delay.

5.2 The CEO shall ensure that the accounts of the Company are kept in accordance with statutory law and accepted practices and that the handling of the property of the Company is secure. The CEO is required to provide information to the Company's Auditors as they consider necessary to discharge their functions.

5.3 The CEO shall serve as a managing director of the Company as provided for by law and may speak for the Company on issues falling within the CEO's mandate.

6 ACCOUNTING AND AUDITING

6.1 The Company's financial year shall be the calendar year. The Board of Directors shall prepare its annual financial statements and annual report for each financial year.

6.2 The annual financial statements, including the consolidated statements, shall be prepared and compiled in accordance with law, good accounting practice and the financial reporting standards which the Company has decided to follow, including with regard to assessments of various items in the financial statements, their presentation, breakdown, notes and nomenclature.

6.3 The Company's Annual General Meeting shall elect an auditor for the Company in accordance with applicable law. The same party shall be elected as auditor of a parent company, affiliate and subsidiary if at all possible. The auditor shall audit the Company's accounts and shall have access to all the Company's accounts and documents for such purpose.

6.4 In other respects, the work and eligibility of the Company's auditor shall be governed by law.

7 AMENDMENTS TO THE COMPANY'S ARTICLES OF ASSOCIATION, MERGER, DIVISION AND DISSOLUTION

7.1 These Articles of Association may be amended at a legally constituted shareholders' meeting by a 2/3 majority of votes cast, and if approved by shareholders controlling at least 2/3 of the share capital represented at the meeting, provided no other proportion is required by law or these Articles of Association for approval.

7.2 If motions for amendments are to be dealt with at a shareholders' meeting an account must be given of the principal substance of such motions in the meeting announcement.

7.3 The provisions of the Act No. 2/1995, on Public Limited Companies and other acts as appropriate shall apply to the Company's winding-up, its merger with other companies or division into two or more legal entities. A decision on such a measure can only be taken by a shareholders' meeting by the same power of votes as is required for amendments to these Articles of Association.

8 MISCELLANEOUS PROVISIONS

8.1 The handling of any aspects not provided for in these Articles of Association shall be governed by the current provisions of the Act No. 2/1995, on Public Limited Companies and the Act No. 161/2002, on Financial Undertakings, and provisions of other legislation as applicable.

8.2 Annexes to the Articles of Association shall be deemed an integral part of it. The Articles of Association are in Icelandic and include an English translation. In the event of a discrepancy between the Icelandic text and the English translation, the Icelandic text shall prevail.

Thus, approved at a shareholders' meeting of Íslandsbanki hf. on 26 May 2021.

LEGAL CONSIDERATIONS AND SUPPLEMENTARY INFORMATION

General Corporate Information

The Bank is a public limited company established for an indefinite period on 9 October 2008 under the Public Limited Companies Act with ID number 491008-0160 in the Register of Enterprises of Iceland. The Bank is domiciled in Iceland, and its registered address is located at Hagasmári 3, 201 Kópavogur, Iceland. The Bank telephone number is +354 440 4000. The Bank's legal entity identifier (LEI) is 549300PZMFIQR79Q0T97.

Significant Subsidiaries and Principal Associates

The Bank is the parent of a number of wholly owned and majority owned subsidiaries. The table below sets forth details of the Bank's significant subsidiaries, in which it held a direct interest as at 31 March 2021.

Subsidiary	Country of Incorporation	Ownership(1)	Company Description
Íslandssjóðir hf. (Iceland Funds)	Iceland	100%	Fund management company
Allianz Ísland hf.	Iceland	100%	Insurance agent
BVS ehf.	Iceland	64.46%	Holding company of VISA shares

(1) Ownership interests are held directly through the Bank or through wholly owned subsidiaries of the Bank.

Other insignificant subsidiaries of the Bank are Ergo ehf., Kreditkort ehf. and Miðengi ehf. Ergo ehf. and Kreditkort ehf. are inactive and not operational. Miðengi ehf. is held for sale.

The table below sets forth details of the Bank's interests in its principal associates as at 31 March 2021.

Associate	Ownership	Company Description
Reiknistofa bankanna hf. (RB)	30.1%	Banking infrastructure provider
JCC ehf.	33.3%	Joint bank-cash centre provider
Auðkenni hf.	23.8%	E-commerce security solutions provider

Material Contracts

Presented below are material contracts (other than contracts entered into in the ordinary course of business), into which either the Bank or its subsidiaries has entered into within the two years immediately preceding the date of this Prospectus, as well as any other contract (other than contracts entered into in the ordinary course of business) that either the Bank or its subsidiaries has entered into that contains obligations or entitlements that are material to the Group as at the date of this Prospectus.

Acquisitions and Disposals

Sale of Borgun

On 11 March 2020 the Bank entered into a share purchase agreement with respect to the Bank's entire stake in Borgun. Pursuant to the agreement the Bank and Eignarhaldsfélagið Borgun sold 95.96% of the total share capital in Borgun to Salt Pay Co Ltd. The agreement was amended with an amendment agreement dated 7 June 2020. The share purchase agreement, as amended, is hereinafter referred to as the "**Agreement**".

The completion pursuant to the Agreement occurred on 7 July 2020 whereby the shares in Borgun were delivered to Salt Pay and one part of the purchase price was paid. The purchase price was to be paid in three parts; on the completion date, on the date falling 6 months after completion and on the date falling 12 months after completion. The first two payments have been paid but the final payment is due in July 2021. Until the purchase price has been fully paid, the majority of the shares are pledged to the Bank as a security for the outstanding payment.

Borgun's 12,987 C-class preferred shares in Visa Inc. ("**Visa Shares**") where not part of the transaction and were transferred to the sellers through capital decrease in Borgun prior to completion. BVS ehf. is the holding company of the Visa Shares. The Bank owns 64.46% of the shares in BVS ehf. and Eignarhaldsfélagið Borgun and other former shareholders of Borgun own the company in same proportion to their former shareholding in Borgun.

Prior to the transaction, Borgun had entered into a hedging arrangement due to its ownership of the Visa Shares that had a negative balance at the time of the transfer of the shares to BVS. To settle the negative balance with Borgun, BVS ehf. entered into a loan agreement with the Bank. The borrowing was presented to the shareholders prior to the transfer of the Visa Shares to BVS ehf., both with a letter dated 17 June 2020 and on the shareholder meeting itself held on 23 June 2020. The outstanding loan was paid in November 2020. One of BVS ehf.'s shareholders has sent a complaint to the District Prosecutor where the shareholder requests that breach of alleged fiduciary duty in respect of the borrowing will be investigated. It is still uncertain whether the District Prosecutor will initiate investigation on the matter and what affect it may have on the Bank.

Sale of Visa shares

BVS ehf. has now sold all its Visa Shares. In late 2020, Visa Inc converted half of BVS ehf.'s Visa Shares into ordinary A-Class shares enabling BVS ehf. to sell the shares on the regulated market. The sale proceeds were used to repay the outstanding loan towards the Bank and the remainder was distributed to its shareholders through a share capital decrease in March 2021. In April 2021 the Banks sold the remaining Visa Shares to a non-related third party. The total sale proceeds for the Visa Shares amounted to USD 28 million.

Underwriting Agreement

For a description of the underwriting agreement that the Bank, the Selling Shareholder and the Managers entered into in relation to the Offering, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

Related Party Transactions

The Bank is wholly owned by the Icelandic state. The Shares are administered by the Selling Shareholder. As a result, the Icelandic state and the Selling Shareholder are defined as related parties.

The Board of Directors and key management personnel of the Bank, the Selling Shareholder and subsidiaries of the Bank are also defined as related parties of the Bank, as are close family members of individuals referred to above and legal entities controlled by them. The Bank's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic state and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner, the Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third-party counterparties.

Cash and balances with the Central Bank of Iceland are disclosed under note 23 and deposits from the Central Bank of Iceland are disclosed under Note 33 of the Annual Financial Statements for the year 2020.

For information regarding remuneration paid to the members of the Board of Directors and Executive Committee, see "*Board of Directors, Executive Committee, Auditor and Corporate Governance—Service Agreements, Remuneration and Entitlements of Members of the Board of Directors and Executive Committee*".

The Group has applied the partial exemption for government-related entities, as described in IAS 24, and does not disclose those transactions for purposes of the "Related party" note in the Annual Financial Statements.

For additional information in relation to the Bank's related party transactions, see the note titled "*Related party*" in the Annual Financial Statements.

Advisors

Citigroup Global Markets Europe AG, Íslandsbanki hf. and J.P. Morgan AG are acting as Joint Global Coordinators and Joint Bookrunners for the Offering; Barclays Bank Ireland PLC, HSBC Continental Europe, Fossar Markaðir hf. and Landsbankinn hf. are acting as Joint Bookrunners for the Offering; Arion banki hf. and Kvika banki hf. are acting as Joint Lead Managers for the Offering; Arctica Finance hf., Íslenskir fjárfestar hf. and Íslensk verðbréf hf. are acting as Co-Lead Managers for the Offering. For information on certain services, among others, which the Managers have provided and may provide in the future to the Bank and the Selling Shareholder, see "*Plan of Distribution and Transfer Restrictions—Plan of Distribution*".

ABN AMRO is acting as financial adviser to the Bank and STJ is acting as financial adviser to the Selling Shareholder in connection with the Offering and the listing of the Offer Shares on Nasdaq Iceland.

White & Case LLP and BBA Fjeldco ehf. are the legal advisors to the Bank and the Selling Shareholder in connection with the Offering and the listing of the Offer Shares on Nasdaq Iceland. Milbank LLP and Logos slf. are the Managers' legal advisors in connection with the Offering and the listing of the Offer Shares on Nasdaq Iceland.

Costs Related to the Offering

The Bank bears all cost associated with the admittance of the Offer Shares to trading. The total cost borne by the Bank is estimated to be ISK 750 million and consists of costs associated with the scrutiny and approval of the Prospectus including paid overtime to employees, the Nasdaq Iceland listing fees, fees to its advisors, along with other costs directly associated with the admittance to trading. The Selling Shareholder bears all costs associated with the marketing and selling of the Offer Shares. The aggregate underwriting commissions, other fees and expenses to be paid by the Selling Shareholder in connection with the Offering are expected to be up to approximately ISK 1,378 million (assuming that the Offer Price is set at the mid-point of the Offer Price Range and the number of Existing Offer Shares sold is the mid-point between 25.0% and 31.8% of the total number of issued Shares and that the Over-Allotment Option is not exercised).

Documents on Display

Copies of the following documents will be on display during ordinary office hours on weekdays for twelve months following the date of this Prospectus at the Bank's offices at Hagasmári 3, 201 Kópavogur, Iceland, or on the Bank's website at www.islandsbanki.is:

(a) the articles of association (with an English translation thereof) of the Bank;

(b) the Annual Financial Statements (with an English translation thereof), in each case, together with the audit reports prepared in connection therewith, and the audited condensed consolidated interim financial statements for the three months ended 31 March 2021. The Bank currently prepares audited consolidated financial statements on an annual basis and unaudited interim consolidated financial statements on a quarterly basis; and

(c) a copy of this Prospectus.

ICELANDIC SECURITIES MARKET

The following describes the Icelandic securities market, including a brief summary of certain provisions of the laws and securities market regulations in Iceland in effect as at the date of this Prospectus. The summary is not intended to provide a comprehensive description of all such regulatory matters and should not be considered exhaustive. Moreover, the laws, rules, regulations and procedures summarised below may be amended or reinterpreted. See "Regulatory Overview—Principal Legislation and Regulations" and "—Proposed Legislative Amendments".

Nasdaq Iceland

Nasdaq Iceland is a regulated market in Iceland, operated by Nasdaq Iceland hf. and is the only Icelandic market on which shares, bonds, derivatives and other securities are traded. Shares trade on Nasdaq Iceland and all transactions, except for interest-bearing financial instruments, are executed through INET. Nasdaq Iceland is a part of the Nordic List, which comprises the exchanges in Denmark, Finland, Iceland and Sweden. Companies on the Nordic List are divided into three segments: large cap, mid cap and small cap, based on their average market value during the given review month. Companies with a market value exceeding EUR 1 billion are in the large cap segment, while companies with a market value between EUR 150 million and EUR 1 billion are in the mid cap segment. Companies with a market value smaller than EUR 150 million belong to the small cap segment. Each segment is normally revised annually at year-end and the segments are reset, with adjustments taking effect on the first trading day in January, based on the average market capitalisation in November of the previous year. The market cap calculations are based on the total number of shares, i.e. both listed and non-listed shares, of a company. Companies whose market capitalisation has moved outside the reference values for their current classification are moved between segments according to the following rule: If their market cap is less than 50.0% of the minimum or more than 150.0% of the maximum threshold of their current segments they are transferred into a new segment with immediate effect. On the other hand, if their market cap is greater than 50.0% of the minimum or less than 150.0% of the maximum threshold of their current segment, they are subject to a transitional period and thus an additional review before transferring into a new segment. Furthermore, companies listed on the Nordic List (including on the Regulated Market of Nasdaq Iceland) are divided into industry sectors in accordance with the globally recognised standard, the Industry Classification Benchmark. This classification is based on the listed company's main operations, i.e. the business area that generates the most revenue for such listed company.

Trading in Securities on Nasdaq Iceland

Trading on Nasdaq Iceland is conducted on behalf of customers by duly authorised Icelandic and foreign banks and other securities brokers as well as the Central Bank of Iceland. While banks and brokers are permitted to act as principals in trading both on and off Nasdaq Iceland, they generally engage in transactions as agents. Clearing and settlement of trades take place through an electronic account-based security system administered by Nasdaq CSD Iceland.

Trading through INET comprises all securities listed on Nasdaq Iceland, except for certain interest-bearing financial instruments, such as bonds. Member firms of Nasdaq Iceland are able to operate from remote locations via computer access. The brokers' representatives are able to trade securities via workstations developed by Nasdaq Iceland or via their own electronic data processing systems that are linked to INET. The round lot for all securities traded on Nasdaq Iceland is one security. In INET, bids and offers are entered in the relevant order book and automatically matched to trades when price, volume and other order conditions are met. INET continuously broadcasts all trading information. The information is displayed in real time in the form of order books, market summaries, concluded trades, index information and different kinds of reports. A two-day settlement schedule (T+2) applies to securities trading.

In respect of equity securities, Nasdaq Iceland's trading hours are 09:30 a.m. to 3:30 p.m. GMT on business days.

In addition to official trading on Nasdaq Iceland through automatic order matching in INET, securities may also be traded off Nasdaq Iceland (i.e., outside INET) during and outside the official trading hours ("**manual trades**"). Ordinarily, manual trades during official trading hours must be entered into at a price within the volume weighted average spread reported in INET at the time of the trade or, for manual trades during the closing call, at the time prior to the closing call auction. Manual trades outside the official trading hours must normally be effected at a price within the volume weighted average spread reported in INET at the close of trading hours. However, in the absence of a spread and in situations where there is a change in the market conditions during the closing call or after the close of trading hours, manual trades outside the official trading hours must be effected at a price that takes into account the market situation at the time of the trade. Manual trades that qualify as large scale (EUR 50,000 to EUR 500,000, depending on the average daily turnover in the relevant security) may be effected without regard to any spread.

All manual trades must normally be reported in INET within three minutes from the time of the trade. Manual trades outside the official trading hours must be reported during the pre-trading session on the following exchange day and not later than 15 minutes prior to the opening of the trading hours.

Securities Market Regulations

The Nordic List (including the Regulated Market of Nasdaq Iceland) is regulated under European Union directives, primarily MiFID, which has been implemented through the Securities Transactions Act. Pursuant to the Stock Exchanges Act, Nasdaq Iceland hf. is authorised to operate a regulated market under the supervision of the FSA. The FSA is a governmental agency which has the task of supervising and monitoring the activities of stock exchanges, regulated securities markets and market participants among other things. The FSA also issues regulations that supplement Icelandic securities market laws and participates in preparing draft legislation. For additional information regarding pending and proposed legislative changes, see "*Regulatory Overview—Principal Legislation and Regulations and "—Proposed Legislative Amendments"*. Furthermore, pursuant to the Stock Exchanges Act, Nasdaq Iceland hf. is required to have its own rules that govern the trading on Nasdaq Iceland, which ensure that any financial instruments admitted to trading in the market are capable of being traded in a fair, orderly and efficient manner and, in the case of securities, are freely negotiable. The Nasdaq Iceland Rules, based on European standards and European Union directives such as MiFID and the Transparency Directive, set forth listing requirements and disclosure rules for companies listed on Nasdaq Iceland. The objective of the regulatory system governing trading on and off Nasdaq Iceland is to achieve transparency, objectivity and equality of treatment among market participants. Nasdaq Iceland records information with respect to the banks and brokers involved, the issuer, the number of shares, the price and the time of each transaction. Each bank or broker must maintain records exhibiting trades carried out as agent or as principal. All trading information reported in INET is publicly available. Through its surveillance activities, Nasdaq Iceland ensures that securities issuers and Nasdaq Iceland members work in accordance with exchange rules. Nasdaq Iceland is furthermore required to notify the FSA of any suspicion or knowledge of any violation of laws, regulations or other rules applicable to trading in a regulated market or any gross or repeated violation of the Nasdaq Iceland Rules.

The Securities Transactions Act, implementing in part the Market Abuse Directive, provides sanctions for insider trading and unlawful disclosure of insider information. The Securities Transactions Act also contains provisions prohibiting market manipulation and makes illegal any actions (in relation to trading on the securities market or otherwise) intended to affect unduly the market price or other conditions of trade in financial instruments or otherwise mislead buyers or sellers of such instruments, such as through spreading false or misleading information. Under Icelandic law, market manipulation may also constitute fraud. In cooperation with Nasdaq Iceland, the FSA enforces compliance with the Securities Transactions Act and other insider trading rules. Nasdaq Iceland enforces compliance with its rules and is obligated under the Stock Exchanges Act to inform the FSA if it suspects any violations of securities market legislation. Criminal offences are enforced in court by the Icelandic District Prosecutor (*Héraðssaksóknari*). Moreover, the FSA may cause the operating licence of a bank or broker to be revoked, if the bank or broker has engaged in improper conduct, including market manipulation. Nasdaq Iceland monitors trading data for indications of unusual market activity and trading behaviour.

Subject to necessary consents and fulfilment of requirements thereof, the Bank may at some point want to change the current electronic registration of the Shares and register the Shares with Verðbréfamiðstöð Íslands hf., which is an authorised Central Securities Depository pursuant to the Central Securities Depositories Act. The Bank holds a 3.4% equity share in Verðbréfamiðstöð Íslands hf.

Securities Registration

Shares are registered in the account-based electronic securities system operated by Nasdaq CSD Iceland, the Icelandic branch of Nasdaq CSD SE, which operates in the Baltic countries as well as in Iceland. Nasdaq CSD SE is authorised to act as an operator of the Icelandic settlement system in accordance with the Central Securities

Depositories Act. Among other things, Nasdaq CSD Iceland maintains the register of shareholders in Icelandic companies listed on Nasdaq Iceland. Shares administered by Nasdaq CSD Iceland are registered in book-entry form on securities accounts and no share certificates are issued. Title to shares can exclusively be ensured through registration with Nasdaq CSD Iceland. A statement from Nasdaq CSD Iceland concerning title to shares in a company constitutes an adequate share register and is valid proof of title to shares in that company. All transactions and other changes to accounts are entered in the system of Nasdaq CSD Iceland through banks or other securities institutions that have been approved as system participants by Nasdaq CSD Iceland.

Shares may be registered on securities accounts and subsequently entered in the register of shareholders, either in the name of the beneficial owner (owner registered shares) or in the name of a nominee authorised by Nasdaq CSD Iceland (nominee registered shares), in which case a note thereof is made in the securities system. The relationship between the nominee and the beneficial owner is governed by agreement. In order to exercise certain rights, for example participation at a general meeting of shareholders, those shareholders whose shares are registered in the name of a nominee must temporarily re-register the shares in their own names. Nominees are also required to report the holdings of underlying beneficial owners to Nasdaq CSD Iceland on a regular basis.

The rights attaching to shares that are eligible for dividends, rights issues or bonus issues accrue to those holders whose names are recorded in the register of shareholders at a particular record date, and the dividends are normally distributed to bank accounts as specified by the holders registered with Nasdaq CSD Iceland. The relevant record date must be specified in the resolution declaring a dividend or capital increase, or any similar matter in which shareholders have preferential rights. Where the registered holder is a nominee, the nominee receives, for the account of the beneficial owner, dividends and other financial rights attaching to the shares, such as subscription rights in conjunction with rights offerings, as well as new shares subscribed through the exercise of subscription rights. Dividends are remitted in a single payment to the nominee who is responsible for the distribution of such dividends to the beneficial owner. A similar procedure is applied for subscription rights and newly issued shares.

Compensation Scheme for Investors

Pursuant to the Deposit Guarantees Act, commercial banks, savings banks, companies providing investment services and other parties engaging in securities trading pursuant to Icelandic law and established in Iceland shall be members of the Depositors' and Investors' Guarantee Fund. Investor compensation is payable only if, in the opinion of the FSA, an institution is unable to render payment of the amount of securities or is declared bankrupt and it is impossible for the investor to recover its securities or cash. The investor compensation does not cover financial loss as a result of changes in value of shares and other securities.

Investor compensation covers securities handled by securities companies, securities brokers and certain other institutions on behalf of customers in the course of providing investment services, such as the purchase, sale and deposition of financial instruments. For the purposes of the scheme, securities refers to securities that are either in the custody or under the administration or supervision of a member company of the compensation scheme, which is under obligation to effect refunding or return thereof in accordance with existing laws or contracts.

There is no cap on the compensation that can be obtained by investors in securities, provided that the securities department of the compensation scheme is adequately financed. In the event that the assets are insufficient to pay the total amount of guaranteed securities and cash in the member companies concerned, payments from the securities department shall be divided among the claimants as follows: each claim up to EUR 20,887 will be paid in full (but only if sufficient funds are available to pay all claims up to EUR 20,887 and, if not, then claims will be paid in equal proportions) and any amount in excess of EUR 20,887 shall be paid in equal proportions depending on the extent of the department's assets. No further claims can be made against the Depositors' and Investors' Guarantee Fund at a later stage even if claimants have not been fully compensated for losses suffered.

Transactions and Ownership Disclosure Requirements

Under the Disclosure Requirements Act, which implements major parts of the Transparency Directive, as amended, a shareholder is required to notify both the company in which it holds shares and the FSA, as soon as possible, and no later than the four business days following the date on which the notification requirement arose, when its voting rights attached to the shares (including options for shares) reach, exceed or fall below 5.0%, 10.0%, 15.0%, 20.0%, 25.0%, 30.0%, 35.0%, 40.0%, 50.0%, 66 2/3rds % or 90.0% of the total number of votes in a company. For the purposes of calculating a person's or entity's shareholding, the shares and financial instruments directly held by the shareholder are included, in addition to those held by related parties, or third parties where there is a contractual arrangement in place with respect to voting rights if favour of the person or entity in questions. The Disclosure Requirements Act sets out a list of related parties whose shareholding must be aggregated for the purposes of the disclosure requirements and situations where third parties' shareholding is aggregated due to contractual arrangements. Related parties include, but are not limited to, subsidiaries, proxies and parties to shareholders' agreements.

Mandatory Bids and Squeeze-Out Proceedings

If the Bank's shares are admitted to trading on Nasdaq Iceland, the Bank will become subject to chapter X of the Securities Transactions Act. Paragraph 1 of Article 100 of the aforementioned act states that if a party, directly or indirectly gains control of a company that has a class of shares which has been admitted to trading on a regulated market, that person shall no later than four weeks after the person knew or could be expected to have known about the mandatory bid obligation, or a decision on the bid was available, extend a takeover bid to other shareholders of the company, i.e. a bid to purchase their shares in the company.

Control of the Bank means that the party and any party acting in concert with it has acquired:

i. in total at least 30% of the voting rights in the Bank;

ii. the right to control at least 30% of the voting rights in the Bank by virtue of an agreement with other shareholders; and

iii. the right to appoint or dismiss the majority of the members of the Bank's Board of Directors.

This applies where the increased holding is the result of a purchase, subscription, conversion or any other form of acquisition of shares in the target company (other than a public offer) or by establishing a close relationship. A related party can be an entity within the same corporate group as the buyer, a spouse, co-habitant or minor child, as well as any person or entity that cooperates with the buyer to obtain control over the company or with whom the buyer has reached an agreement regarding the coordinated exercise of voting rights with the aim of obtaining a long-term controlling influence on the company's management. An authorisation from the FSA is required to permit the acquirer (or the related party) to reduce its level of voting share ownership within the grace period of four weeks to below 30.0%.

Under the Securities Transactions Act and the Public Limited Companies Act, a shareholder with shares representing more than 90.0% of all shares in a company has the right to redeem remaining shares in that company. Regarding companies with shares traded on a regulated market, such as Nasdaq Iceland, the redemption value must correspond to the market value, unless exceptional reasons (such as following a takeover bid) require otherwise. In addition, any minority shareholder that possesses shares that may, pursuant to the Securities Transactions Act and the Public Limited Companies Act, be redeemed by a majority shareholder is entitled to require such majority shareholder to redeem its shares.

TAXATION

The following is a summary of certain tax consequences that may arise from the Offering and is intended as general information only. The statements concerning Icelandic tax laws and U.S. federal income tax laws set forth below, including concerning the U.S.-Iceland Treaty and the Nordic Tax Treaty, are based on the laws and regulations as at the date of this Prospectus and are subject to any changes in Icelandic or U.S. law or in the U.S.-Iceland Treaty, or the Nordic Tax Treaty, occurring after such date, which changes may have retroactive effect.

Certain Tax Considerations in Iceland

The comments below are of a general nature based on the Bank's understanding of current law and practice in Iceland. Prospective investors who are in any doubt as to their personal tax position or who may be subject to tax in any other jurisdiction should consult their professional advisers. Furthermore, prospective investors should note that the holding of beneficial ownership in Shares via an intermediary or the appointment of any person through which an investor holds the Shares may have tax implications; such holding via an intermediary is not explicitly addressed in Icelandic tax law, resulting in some uncertainties in respect of Icelandic withholding tax which might be applied to the beneficial owner rather than the intermediary.

Prospective investors of the Offer Shares are advised to consult with their tax advisers as to the consequences, under tax laws of Iceland and the countries of their respective citizenship, residence or domicile, of a purchase of the Offer Shares, which may have impact on the income received from the securities, including but not limited to, the consequences of receipt of dividend payments in respect of the Offer Shares and disposal or redemption of the Offer Shares.

The summary below is of a general nature based on the laws and practices as in effect in Iceland as at the date of this Prospectus. It should not be construed as providing specific advice regarding Icelandic taxation and is subject to any change in laws or practices in Iceland that may take effect after such date. It relates only to the position of persons who are the absolute beneficial owners of the Shares.

Shareholders Who Are Resident in Iceland for Tax Purposes

Owners of the Shares who are resident in Iceland for tax purposes are subject to income tax in Iceland on any income from the Shares in accordance with Icelandic tax laws. The applicable tax rate depends on the tax status of such owners. Subject to certain exemptions, the owners are subject to tax which the Bank is required to withhold at the rate of 22.0% on dividend payments made to the holders of the Shares. Exemptions from withholding tax, based on Act No. 94/1996 on Withholding of Tax on Financial Income, apply for public and private limited companies tax resident in Iceland in addition to domestic pension funds. Such withholding is generally considered a preliminary tax payment but does not necessarily constitute the final tax liability of the holder of the Shares.

Individuals who are resident in Iceland for tax purposes are subject to a final 22.0% tax on dividend payments in Iceland. Limited companies (e.g., ehf. and hf.), which are tax resident in Iceland, enjoy an effective participation exemption, allowing them to deduct the full amount of the dividend payments received.

Capital gains from the sale of the Shares are also subject to 22.0% tax in the case of individuals tax resident in Iceland subject to certain rights to deduct capital losses resulting from the sale of shares or similar assets. Limited companies (e.g., ehf. and hf.), which are tax resident in Iceland, enjoy an effective participation exemption, allowing them to deduct the full amount of the capital gains, as in the case of dividends.

Shareholders Who Are Not Resident in Iceland for Tax Purposes

Article 3(7) of the Income Tax Act provides that any income received from the Shares by any person or entity residing outside Iceland constitutes taxable income in Iceland. According to Article 70(7) of the Income Tax Act, the current tax rate on taxable income under Article 3(7) of the Income Tax Act amounts to (i) 22.0% for individuals and (ii) 20.0% for legal entities. The Bank is required to withhold the applicable tax on any dividend payments. The tax rate applicable to income from any disposal of the Shares is also (i) 22.0% for individuals and (ii) 20% for legal entities.

The tax liability under Icelandic tax laws may be reduced under certain applicable tax treaties. If a qualifying holder of the Shares would like to take advantage of such applicable tax treaties by relief at source, such holder is required to obtain a confirmation from the Icelandic tax authorities regarding the applicable treaty protection and provide such confirmation to the Bank. The confirmation is obtained via a filing of Icelandic tax form RSK 5.42. The U.S.-Iceland Treaty reduces the Icelandic tax rate on capital gains from any disposal of the Shares to 0.0% and Icelandic tax rate on dividend payments to 15.0% for individuals and legal entities and to 5.0% for legal entities only if the shareholding of such legal entities amounts to at least 10.0% of the issued Shares. The same reduction applies in case of the Nordic Tax Treaty with the exception that the dividend tax rate applicable to qualifying legal entities holding at least 10% of the issued share capital is reduced to 0.0%. Relief via a refund in line with an applicable tax treaty is carried out via a filing of Icelandic tax form RSK 5.43. Irrespective of the availability of any tax treaty protection, limited companies resident in the EEA, a state party to EFTA or in the Faroe Islands enjoy the effective statutory participation exemption which comparable Icelandic entities also enjoy, allowing them to deduct the full amount of the dividend payments and capital gains received. This exemption does not apply at source, but requires the filing of a tax return in Iceland to obtain a refund of taxes withheld

There are no estate or inheritance taxes, succession duties or gift taxes imposed by the Icelandic government or any governmental authority in Iceland in respect of the Shares if, at the time of death of the holder of the Shares or transfer of the Shares, such holder or transferor was not a resident of Iceland.

No Icelandic issue tax or stamp duty will be payable in connection with the Shares.

U.S. Federal Income Tax Considerations

The following is a summary of certain U.S. federal income tax consequences of the acquisition, ownership and disposition of the Offer Shares by U.S. Holders (as defined below) and does not address the effects of any U.S. federal tax laws other than U.S. federal income tax laws (such as estate and gift tax laws) or any state, local or non-U.S. tax laws. This summary is based upon the Code, the Treasury Regulations, and judicial and administrative interpretations thereof, each as in effect on the date hereof, and all of which are subject to change, possibly with retroactive effect. This summary does not address all of the U.S. federal income tax consequences that may be relevant to a holder in light of such holder's particular circumstances, including, but not limited to, the impact of the Medicare contribution tax, or to holders subject to special rules, such as certain financial institutions, U.S. expatriates, insurance companies, individual retirement accounts, dealers in securities or currencies, traders in securities, U.S. Holders whose functional currency is not the U.S. dollar, tax-exempt entities, regulated investment companies, real estate investment trusts, partnerships or other pass through entities and investors in such entities, persons liable for alternative minimum tax, U.S. Holders that own (actually or constructively) 10% or more of the Bank voting stock, persons required for U.S. federal income tax purposes to accelerate the recognition of any item of gross income with respect to the Offer Shares as a result of such income being recognised on an applicable financial statement, U.S. Holders that are resident in or have a permanent establishment in a jurisdiction outside the United States and persons holding the Offer Shares as part of a "straddle", "hedge", "conversion transaction" or other integrated transaction.

In addition, this summary is limited to U.S. Holders that acquire the Offer Shares pursuant to the Offering and who hold the Offer Shares as capital assets within the meaning of Section 1221 of the Code. For purposes of this discussion, a "**U.S. Holder**" is a beneficial owner of the Offer Shares that is, for U.S. federal income tax purposes, (i) an individual who is a citizen or resident of the United States, (ii) a corporation or any entity taxable as a corporation created or organised in or under the laws of the United States, any state thereof or the District of Columbia, (iii) any estate the income of which is subject to U.S. federal income taxation regardless of its source, or (iv) any trust if a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust or if a valid election is in place to treat the trust as a U.S. person. If any entity treated as a partnership for U.S. federal income tax purposes holds the Offer Shares, the U.S. tax treatment of a partner in the partnership generally will depend upon the status of the partner and the activities of the partnership. A partnership considering an investment in the Offer Shares, and partners in such a partnership, should consult their tax advisors regarding the U.S. federal income tax consequences of the purchase, ownership and disposition of the Offer Shares.

Prospective purchasers of the Offer Shares should consult their tax advisors concerning the tax consequences of holding Offer Shares in light of their particular circumstances, including the application of the U.S. federal income tax considerations discussed below, as well as the application of other federal, state, local, non-U.S. or other tax laws.

Distributions on the Offer Shares

Subject to the discussion in "*Passive Foreign Investment Company Rules*", a distribution of cash or property with respect to the Offer Shares (including the amount of any taxes withheld) will generally be treated as a dividend to the extent paid out of the Bank's current or accumulated earnings and profits, as determined under U.S. federal income tax principles, and will be includible in the gross income of a U.S. Holder on the date the distribution is actually or constructively received. The Bank does not expect to maintain calculations of its earnings and profits under U.S. federal income tax principles and, therefore, U.S. Holders should expect that the entire amount of any distribution generally will be reported as dividend income for U.S. federal income tax purposes. Any such dividend income will not be eligible for the dividends-received deduction generally allowed to corporate U.S. Holders with respect to dividends received from other U.S. corporations. Subject to certain holding period requirements and other conditions, dividends paid to non-corporate U.S. Holders may be eligible for preferential rates of taxation if the dividends are "qualified dividends" for U.S. federal income tax purposes. Dividends received with respect to the Offer Shares will be qualified dividends if the Bank: (i) is eligible for the benefits of a comprehensive income tax treaty with the United States that the IRS has approved for the purposes of the qualified dividend rules; and (ii) was not, in the year prior to the year in which the dividend was paid, and is not, in the year in which the dividend is paid, a PFIC for U.S. federal income tax purposes.

The U.S.-Iceland Treaty has been approved for the purposes of the qualified dividend rules and the Bank expects that it will generally be eligible for the benefits of the U.S.-Iceland Treaty. In addition, the Bank believes that it was not a PFIC for its taxable year ended 31 December 2020 and, although no assurance can be given, it does not anticipate becoming a PFIC for its current taxable year or any foreseeable future taxable year. See "*Passive Foreign Investment Company Rules*". Dividends paid in a currency other than U.S. dollars will be included in income in a U.S. dollar amount determined by reference to the exchange rate in effect on the date of actual or constructive receipt by the U.S. Holder (in the case of Offer Shares), whether or not the non-U.S. currency is converted into U.S. dollars at that time.

A U.S. Holder's tax basis in the non-U.S. currency received will equal the U.S. dollar amount included in income. Any gain or loss realised on a subsequent conversion or other disposition of the non-U.S. currency for a different U.S. dollar amount will be exchange gain or loss and generally will be treated as U.S. source ordinary income or loss for foreign tax credit limitation purposes. If a dividend paid in non-U.S. currency is converted into U.S. dollars on the day the dividend is received, the U.S. Holder generally will not be required to recognise non-U.S. currency gain or loss in respect of the dividend.

For purposes of calculating the foreign tax credit, dividends paid on the Offer Shares will be treated as income from sources outside the United States and will generally constitute passive category income. The rules governing the foreign tax credit are complex. U.S. Holders should consult their own tax advisors regarding the tax consequences to it if Icelandic tax is withheld from dividends on the Offer Shares, including the availability of the foreign tax credit under its particular circumstances.

Sale, Exchange, Redemption, or Other Taxable Disposition of Offer Shares

Subject to the discussion in "*Passive Foreign Investment Company Rules*", a U.S. Holder will generally recognise capital gain or loss on the sale, exchange, redemption or other taxable disposition of the Offer Shares in an amount equal to the difference between the amount realised upon the disposition and the U.S. Holder's adjusted tax basis in such Offer Shares. Any such capital gain or loss will be long-term if the U.S. Holder's holding period for the Offer Shares exceeds one year. The deductibility of capital losses may be subject to limitations. A U.S. Holder's tax basis in the Offer Shares generally will be the U.S. dollar value of the non-U.S. currency amount paid to purchase the Offer Shares determined by reference to the exchange rate on the date of purchase. If the Offer Shares are treated as traded on an established securities market, a cash basis U.S. Holder (or, if it elects, an accrual basis U.S. Holder) will determine the U.S. dollar value of the cost of such Offer Shares by translating the amount paid at the spot rate of exchange on the settlement date of the purchase.

A U.S. Holder that receives a currency other than U.S. dollars on the sale or other taxable disposition of the Offer Shares generally will realise an amount equal to the U.S. dollar value of the non-U.S. currency received determined by reference to the exchange rate on the date of sale or other taxable disposition (or in the case of the Offer Shares traded on an established securities market that are sold by a cash basis or electing accrual basis taxpayer, the settlement date). A U.S. Holder will recognise foreign currency gain or loss if the U.S. dollar value of the currency received at the spot rate on the settlement date differs from the amount realised. A U.S. Holder will have a tax basis in the currency received equal to the U.S. dollar value of the currency on the settlement date. Any gain or loss realised on a subsequent conversion or other disposition of the non-U.S. currency for a different U.S. dollar amount will be exchange gain or loss and generally will be treated as U.S. source ordinary income or loss for foreign tax credit limitation purposes.

Passive Foreign Investment Company Rules

A non-U.S. corporation is classified as a PFIC for U.S. federal income tax purposes for each taxable year in which: (a) 75.0% or more of its gross income is passive income (as defined for U.S. federal income tax purposes) or (b) 50.0% or more (by value) of the average quarterly value of its gross assets either produce, or are held for the production of, passive income. For purposes of the PFIC provisions, passive income generally includes dividends, interest, royalties, rents and gains from some securities transactions.

The application of the PFIC rules to banks is unclear under present U.S. federal income tax law. Banks generally derive a substantial part of their income from assets that are interest bearing or that otherwise could be considered passive under the PFIC rules. The IRS recently issued proposed U.S. Treasury Regulations (the "**2021 Proposed Regulations**"), and previously issued a notice in 1989 (Notice 89-81, the "**Notice**") and proposed regulations in 1995 (as amended in 1998, the "**1998 Proposed Regulations**"), that exclude from passive income any income derived in the active conduct of a banking business by a qualifying foreign bank (the "**active bank exception**"). The 2021 Proposed Regulations are proposed to be effective for taxable years of shareholders beginning on or after January 14, 2021, while the 1998 Proposed Regulations are proposed to be effective for taxable years beginning after December 31, 1994 and provide that taxpayers may apply the 1998 Proposed Regulations to a taxable year beginning after December 31, 1986, provided the 1998 Proposed Regulations are consistently applied to that taxable year and all subsequent taxable years.

The 2021 Proposed Regulations, the Notice, and the 1998 Proposed Regulations each have different requirements for qualifying as a foreign bank, and for determining the banking income that may be excluded from passive income under the active bank exception, but the preamble to the 2021 Proposed Regulations authorises taxpayers to rely upon the Notice or the Notice to determine whether income of a foreign bank may be treated as non-passive. Under both the 2021 Proposed Regulations and the 1998 Proposed Regulations, a qualifying foreign bank must be licensed in the country of its incorporation to do business as a bank and must also carry on one or more specified activities, including regularly receiving bank deposits from unrelated customers in the course of its banking business. While the 2021 Proposed Regulations are silent on this matter, under both the Notice and 1998 Proposed Regulations, loans made in the ordinary course of a banking business are not treated as passive assets. Under the Notice, however, interbank deposits are not treated as loans made in the ordinary course of a banking business, subject to certain exceptions. Under the 1998 Proposed Regulations, however, such deposits are treated as loans made in the ordinary course of a banking business, and, therefore, would not be treated as passive assets.

Although the rules for determining the PFIC status of a foreign bank under the Notice, the 2021 Proposed Regulations and the 1998 Proposed Regulations are not free from doubt, the Bank believes that it should qualify as an active bank under both the Notice and both the 1998 and 2021 Proposed Regulations, assuming that the 1998 Proposed Regulations and the 2021 Proposed Regulations are finalised in their current form, based upon the Bank's regulatory status under Icelandic law, its banking activities performed in the ordinary course of business (including lending and accepting deposits), the proportion of its income derived from activities that are "*bona fide*" banking activities for U.S. federal income tax purposes and its securities activities performed in the ordinary course of business. Accordingly, the Bank does not expect to be classified as a PFIC for U.S. federal income tax purposes for its taxable year ended on 31 December 2020, the current taxable year or in the foreseeable future taxable years, although there can be no assurances in this regard. The Bank's status as a PFIC in any year depends on its assets and activities in that year. Additionally, the determination is based in part on the 2021 Proposed Regulations and the 1998 Proposed Regulations which may be subject to change as and when adopted as final regulations.

If the Bank is considered a PFIC at any time that a U.S. Holder holds Offer Shares, unless a U.S. Holder is eligible to, and elects to be taxed annually on a mark to market basis with respect to the Offer Shares, as described below, any gain recognised by the U.S. Holder on a sale or other disposition of the Offer Shares, as well as the amount of an "excess distribution" (defined below) received by such holder, would be allocated ratably over the U.S. Holder's holding period for the Offer Shares. The amounts allocated to the taxable year of the sale or other disposition (or the taxable year of receipt, in the case of an excess distribution) and to any year before the Bank became a PFIC would be taxed as ordinary income. The amount allocated to each other taxable year would be subject to tax at the highest rate in effect for individuals or corporations, as appropriate, for that taxable year, and an interest charge would be imposed. For purposes of these rules, an excess distribution is the amount by which any distribution received by a U.S. Holder on its shares in a taxable year exceeds 125% of the average of the annual distributions on the shares received during the preceding three years or the U.S. Holder's holding period, whichever is shorter. If the Bank is treated as a PFIC and, at any time, the Bank invests in non-U.S. corporations that are classified as PFICs ("**Subsidiary PFICs**"), U.S. Holders generally will be deemed to own, and also would be subject to the PFIC rules with respect to, their indirect ownership interest in that Subsidiary PFIC. If the Bank is treated as a PFIC, a U.S. Holder could incur liability for the deferred tax and interest charge described above if either (1) the Company receives a distribution from, or disposes of all or part of its interest in, a Subsidiary PFIC or (2) the U.S. Holder disposes of all or part of its Offer Shares.

Certain elections may be available that would result in alternative treatments (such as mark-to-market treatment as discussed below) of the Offer Shares, which in certain circumstances might mitigate the impact of the tax consequences. The Bank does not intend to provide the information necessary for U.S. Holders of the Offer Shares to make qualified electing fund elections, which, if available, would result in a tax treatment different from the general tax treatment for an investment in a PFIC described above.

A U.S. Holder of stock in a PFIC (but not a Subsidiary PFIC, as discussed below) may make a "mark to market" election, provided the PFIC stock is "marketable stock" as defined under applicable U.S. Treasury Regulations (i.e., "regularly traded" on a "qualified exchange" or "other market"). Under applicable U.S. Treasury Regulations, a "qualified exchange" includes a national securities exchange that is registered with the SEC or the national market system established under the Exchange Act, or a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and meets certain trading, volume, listing, financial disclosure and other requirements. Under applicable U.S. Treasury Regulations, PFIC stock traded on a qualified exchange is regularly traded on such exchange for any calendar year during which such stock is traded, other than in de minimis quantities, on at least 15 days during each calendar quarter. The Bank cannot assure U.S. Holders that the Shares will be treated as "marketable stock" for any taxable year.

If a "mark-to-market'" election is available and a U.S. Holder validly makes such an election as of the beginning of the U.S. Holder's holding period, the U.S. Holder generally will not be subject to the adverse tax consequences relating to an excess distribution or gain described above. Instead, the U.S. Holder generally will be required to take into account the difference, if any, between the fair market value of, and its adjusted tax basis in, its Offer Shares at the end of each taxable year as ordinary income or, to the extent of any net mark-to-market gains previously included in income, ordinary loss, and to make corresponding adjustments to the tax basis of its Offer Shares. In addition, any gain from a sale, exchange or other disposition of Offer Shares will be treated as ordinary income, and any loss will be treated as ordinary loss to the extent of any net mark-to-market gains previously included in income. However, a mark-to-mark election with respect to Offer Shares will not apply with respect to interests in a Subsidiary PFIC. Each U.S. Holder should consult its own tax advisor with respect to the availability and tax consequences of a mark-to-market election with respect to Offer Shares and the U.S. Holder's indirect interest in a Subsidiary PFIC.

Under the PFIC rules, if the Bank was considered a PFIC at any time that a U.S. Holder holds the Offer Shares, the Bank would continue to be treated as a PFIC with respect to such holder's investment unless (i) the Bank ceases to be a PFIC and (ii) the U.S. Holder has made a "purging" election under the PFIC rules. Under the purging election, the U.S. Holder will be deemed to have sold such Offer Shares at their fair market value and any gain recognised on such deemed sale will be treated as an excess distribution, as described above. As a result of the purging election, the U.S. Holder will have additional basis (to the extent of any gain recognised on the deemed sale) and, solely for purposes of the PFIC rules, a new holding period in the Offer Shares.

If a U.S. Holder owns Offer Shares during any taxable year in which the Bank is a PFIC, such holder will generally be required to file an IRS Form 8621 annually with respect to the Bank, generally with the U.S. Holder's U.S. federal income tax return for that year unless specified exceptions apply. Significant penalties are imposed for failure to file IRS Form 8621, and the failure to file such form may suspend the running of the statute of limitations. U.S. Holders should consult their tax advisors regarding the application of the PFIC rules, and the availability of certain elections, to their investment in the Offer Shares.

Information Reporting and Backup Withholding Requirements

Dividends on the Offer Shares and proceeds from the sale or other taxable disposition of the Offer Shares by a U.S. paying agent or other U.S. intermediary, or made into the United States, generally will be reported to the IRS unless the holder is a corporation or otherwise establishes a basis for exemption. Backup withholding generally will apply to amounts subject to reporting if the U.S. Holder fails to provide an accurate taxpayer identification number or certification of exempt status. Any amount withheld may be credited against the U.S. Holder's U.S. federal income tax liability, if any, or refunded to the extent it exceeds the U.S. Holder's liability provided the required information is timely furnished to the IRS. Prospective investors should consult their own tax advisors as to their qualification for exemption from backup withholding and the procedure for establishing an exemption. Certain U.S. Holders may be required to report to the IRS certain information relating to an interest in the Offer Shares unless such Offer Shares are held in accounts maintained by certain financial institutions. A U.S. Holder required to report such information must file a complete IRS Form 8938 (Statement of Specified Foreign Financial Assets) with its tax return for each year in which it holds an interest in the Offer Shares. Penalties apply if a U.S. Holder is required to submit such information to the IRS and fails to do so. U.S. Holders should consult their tax advisors regarding the application of these rules in their particular circumstances.

TERMS AND CONDITIONS OF THE OFFERING

General Terms

The Offering applies to already issued shares in the Bank held by the Selling Shareholder, to be offered in the form of Existing Offer Shares. The Selling Shareholder will closely consult with the Joint Global Coordinators and agree on the final number of the Offer Shares sold in the Offering, and in any case the Offering will comprise Existing Offer Shares representing a maximum of 31.8% of the total issued and outstanding share capital.

All Offer Shares being sold to investors pursuant to the Offering will be sold at the Offer Price. The Offering is being made by way of:

(a) a public offering of the Offer Shares in Iceland to retail and institutional investors in accordance with the Prospectus Act, as described below; and

(b) an institutional offer of the Offer Shares: (i) to certain institutional investors outside the United States in reliance on Regulation S and in accordance with locally applicable laws and regulations; and (ii) in the United States, only to QIBs in reliance on Rule 144A or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act (see "*Plan of Distribution and Transfer Restrictions*").

The Offering is made only in those jurisdictions where, and only to those persons to whom, offer and sales of the Offer Shares may be lawfully made. Investors participating in the Offering will be deemed to have confirmed they meet the requirements of the selling and transfer restrictions set out in this Prospectus. If in doubt, investors should consult their professional advisers.

It is expected that the result of the Offering will be published on 15 June 2021 and posted on the Bank's website. It is furthermore expected that Nasdaq Iceland will subsequently respond to the Bank's applications to admit the Shares to trading on the regulated market of Nasdaq Iceland. Subsequently, information on the allocation of the Offer Shares to investors in the Offering (i.e. confirmation or reduction of subscriptions) will be sent to investors, expected on 16 June 2021 if Nasdaq Iceland have responded positively. The final due date for payment of the allocated shares is then set for 21 June 2021 and paid Offer Shares are expected to be delivered to the investors within two business days after payment is received.

The Selling Shareholder will cancel the Offering if Nasdaq Iceland rejects the Bank's application to have all Shares in the Bank admitted to trading on the regulated market of Nasdaq Iceland. The Selling Shareholder reserves the right to cancel the Offering if orders are not received for at least the minimum number of the Offer Shares in the Offering, if it is not able to obtain a satisfactory Offer Price within the Offer Price Range, or for any other reason in its sole discretion. In such an event the Selling Shareholder will publish an announcement thereof.

If the Offering is cancelled pursuant to the above, all orders for Offer Shares in the Offering and allocations made on the basis thereof will be invalidated as a result. It will be publicly announced if the Offering is cancelled or if the Offer Period is accelerated, extended or postponed, following which (other than in the case of cancellation of the Offering) a supplement to this Prospectus will be prepared, approved and published in accordance with Article 23 of the Prospectus Regulation and Article 5 of the Prospectus Act, as applicable. In such case (other than in the case of cancellation of the Offering), investors may be able to withdraw their orders (see further "*—Withdrawal Rights*").

Investors in the public offering in Iceland can obtain information on the Offering and the order website from the Bank at www.islandsbanki.is/utbod. Further information on the Offering for investors participating in Tranche A (as described below) is available from the Bank at tel. +354 440 4000 or via email verdbref@islandsbanki.is, and for those investors participating in Tranche B (as described below) via tel. +354 440 4000 or via email ipo@islandsbanki.is. Investors can obtain this information by phone or e-mail between 09:00 and 16:00 GMT during the Offer Period.

Offer Period

Subject to any acceleration, extension or postponement of the timetable for the Offering, the offer period in respect of the public offerings in Iceland begins on 7 June 2021 at 09:00 GMT and ends on 15 June 2021 at 12:00 GMT (the "**Offer Period**"). No orders will be accepted after the Offer Period has ended (unless the Selling

Shareholder specifically decides to postpone the Offering or to extend it and in such cases a supplement to this Prospectus will be published, as applicable). The Selling Shareholder reserves the right to accelerate, extend or postpone the Offer Period.

Offer Price Range and number of Offer Shares

The price at which the Offer Shares will be sold (the "**Offer Price**") is expected to be between ISK 71 and ISK 79 per Offer Share (the "**Offer Price Range**") and will be determined through a book-building process. The Offer Price will be set in ISK.

The number of Existing Offer Shares will represent a maximum of 31.8% of the total issued and outstanding share capital.

The Offer Price and number of Offer Shares will be determined by the Selling Shareholder, in consultation with the Joint Global Coordinators, after the end of the Offer Period, and subject in all cases to final approval by the Minister.

Over-Allotment Option

The Selling Shareholder has granted the Joint Global Coordinators, on behalf of the Managers, an option (the "**Over Allotment Option**"), to purchase up to 63,636,363 additional Shares (the "**Over-Allotment Shares**") at the Offer Price, comprising up to 10% of the total number of Existing Offer Shares sold in the Offering, to cover short positions resulting from any over-allotments and stabilisation transactions, if any, made in connection with the Offering. The Over-Allotment Option is exercisable in whole or in part by the Joint Global Coordinators (as defined below), on behalf of the Managers, for 30 calendar days after the First Trading Date.

For purposes of enabling the Managers to effect timely delivery of any Over-Allotment Shares, up to 63,636,363 Shares will be made available by the Selling Shareholder to the Joint Global Coordinators, on behalf of the Managers, through a share loan contained in the Underwriting Agreement.

Allocation

The allocation of the Offer Shares is expected to take place after termination of the Offer Period on or about 16 June 2021, subject to acceleration or extension of the Offer Period. Shortly thereafter, those investors that have received allocation in the Offering will be sent a notification by email informing them that final allocation can be viewed through the subscription system. Those persons who have not been allotted Offer Shares will not receive a notification. Investors are responsible for ensuring that the e-mail address provided is valid and able to receive the necessary documentation.

Allotment to investors who applied to purchase Offer Shares will be determined by the Selling Shareholder after consultation with the Joint Global Coordinators and will be subject to final approval by the Minister. Full discretion will be exercised as to whether or not and how to allot the Offer Shares (which means that the Selling Shareholders or the Joint Global Coordinators are not required to disclose how the reduction or rejection was decided and the counterparty will not be given the opportunity to object to the decision or its application). As a general allocation principle the Selling Shareholder will apply criteria designed to fulfil the requirements of the applicable legislation including Act No. 155/2012 and Act No. 88/2009, the Government's Ownership Policy, the Minister's Decision and accepted market practices.

During the bookrunning period orders will be categorised in Tranche A and Tranche B depending on the size of the orders. The categorisation, however, will have no bearing on allocation between these tranches. See further detailed below *"Subscriptions"*.

There will no pre-determined allocation of the Offer Shares between Tranche A and Tranche B.

In addition to the general allocation principles listed above, subscriptions in Tranche A, that are intended for investors with Icelandic ID numbers, are expected to benefit from a preferential allocation. For example, the Minister's Decision recommended that subscriptions of up to a minimum of ISK 1,000,000 will be fully allocated. In this respect, it is intended that orders in Tranche A up to ISK 1,000,000 will not be curtailed in case of oversubscription, unless such subscriptions exceed the size of the Offering, in which case such subscriptions would be reduced to the extent required. Orders in Tranche A from investors amounting over ISK 1,000,000 may be subject to reduction for the portion of the order amount that exceeds ISK 1,000,000.

In addition to the general allocation principles listed above subscriptions in Tranche B will be subject to the requirements of the applicable legislation and the overall objectives of the Offering, i.e. diversifying the shareholder base, encouraging increased liquidity of the Offer Shares, selling the Offer Shares at the best price for the Selling Shareholder and an orderly secondary market, orders from institutional investors with the following characteristics, among other things, will be given key consideration in the allocation process: timeliness of submission of orders, price leadership (where "price leadership" means accepting orders put forward at top of the Offer Price Range or orders that are listed as price takers), consistency of order size during the process and interest in the Bank, and detail and quality of feedback provided including granular views on the valuation of the Bank.

Allotment to investors who applied to purchase Offer Shares will be made on a systematic basis using both quantitative and qualitative measures of the above criteria. Nevertheless, the Selling Shareholder reserves the right to exercise full discretion as to whether or not and how to allot the Offer Shares. In the event that the Offering is over-subscribed, investors may receive fewer Offer Shares than they applied for. The Selling Shareholder may at its own discretion and without stating the grounds therefor, reject any subscriptions wholly or partly, even if any or all of the abovementioned criteria are met. Further, efforts will be made to allocate Offer Shares to the potential market maker in the Bank's shares after the Offering.

On the date of allocation, the Joint Global Coordinators will notify institutional investors or the relevant financial intermediary regarding allotment of Offer Shares to them or their clients. Investors who are not allocated any Offer Shares will not receive a notification to that effect.

Íslandsbanki on behalf of the Joint Global Coordinators will consolidate all orders submitted by investors and inform the Selling Shareholder, Joint Global Coordinators and the Bank.

Payment

Payment will not be accepted by any other means than those stated in the payment instructions provided by the Joint Global Coordinators (the "**Payment Instructions**").

Payment shall be made at the latest before the closing time of banks in Iceland on the final due date. Investors are advised that the general opening hours of banks and other financial institutions are until 16:00 GMT on weekdays and that after 16:15 GMT it is not possible to make a payment exceeding ISK 10,000,000. However lower payments are possible via online banks until 21:00 GMT, provided that the amount is below other limits which may apply.

Payment will not be accepted by any other means than those stated in the Payment Instructions. Full payment must be made on or before the date stated in the Payment Instructions. Investors must pay the Offer Price in immediately available funds in full in ISK on or before on 21 June 2021.

The Joint Global Coordinators reserve the right to:

- request investors for proof of funds for any submitted order. Failure to provide sufficient proof of funds can result in the order being invalidated;
- request information from investors to conclude any necessary know-your-customer (KYC) review. Failure to provide information necessary for KYC review may result in cancellation in full of such investors' orders or in investors not being able to trade or move the Offer Shares until the necessary information is provided;
- demand confirmation of investors' ability to pay and/or collateral for payment from investors. If investors do not agree to this demand from the Joint Global Coordinators before the close of the subscription period or before the end of any other deadline in relation to the Offering, the Joint Global Coordinators reserve the right to reject and invalidate the subscription of the investor, wholly or partly. The Joint Global Coordinators have sole discretion to decide whether confirmation of the ability to pay and/or collateral is sufficient. Sole discretion means that the Joint Global Coordinators will assess each confirmation separately and they are not obliged to reveal how the decision was made and the counterparty will not be given the opportunity to object to the decision or its application.

If full payment is not made in due time according to the Payment Instructions, allotted Offer Shares may be withdrawn and sold to another party. In the event of such a transfer, should the selling price be less than the price in the Offering, the party who initially received allocation of Offer Shares in the Offering may be responsible for the difference.

After the final due date, the Selling Shareholder may, without warning or notification, invalidate allocations which remain uncollected at the end of the final due date. The Selling Shareholder is then entitled to retain Offer Shares which have not been paid for or decide a price at which to sell them to a third party. However, if the Selling Shareholder is unable to sell the unpaid Offer Shares to a third party at the same or higher price than they were allocated in the Offering, the Selling Shareholder reserves the right to demand that the investor to whom the Offer Shares were originally allocated pay the difference between the sale value of the Offer Shares and the Offer Price. Any such investor will not be entitled to any compensation in the form of Offer Shares or other valuables. The Selling Shareholder reserves the right to validate unpaid orders and to collect allocations which are not paid satisfactorily and in such an event the Selling Shareholder's collection costs, as well as penalty interest from the final due date, are added to the purchase price of the uncollected Offer Shares. If payment fails to be made at the correct time (i.e. on the final due date) and in the correct manner (i.e., in full compliance with the Payment Instructions) the debt may be collected, potentially through Icelandic courts, in accordance with the applicable principles of contract law.

The responsibility for collection and settlement of all transactions of the Selling Shareholder in connection with the Offering lies with the Joint Global Coordinators. The investor will not incur any special costs in respect of the transaction by the Selling Shareholder or the Joint Global Coordinators. Investors are encouraged to consider whether any costs or fees will be charged by other parties in connection with the transaction.

Neither the Bank nor the Selling Shareholder are aware that individual shareholders or members of the Board of Directors or Executive Committee of the Bank intend to purchase shares in the Offering, nor whether any investor intends to purchase more than 5% of the Offering.

Employees and board members of the Bank or the Managers, and parties closely related to them, may participate in the Offering. In the case of employees and board members of the Bank, and parties closely related to them, such orders must be submitted before 16:00 GMT on 10 June 2021. Such employees, and related parties, shall seek guidance from their respective compliance departments on how to submit their orders and shall in all respects comply therewith. Certain employees of the Bank and parties closely related to them may be subject to further restrictions than others. Employees and board members of the Bank will not be granted additional allocation priority in the Offering. Employees and board members of the Selling Shareholder will not be permitted to participate in the Offering.

Admission of the Offer Shares to Trading

An application has been submitted by the Board of Directors of the Bank to begin the procedure for all Shares in the Bank to be admitted to trading on the regulated market of Nasdaq Iceland. Following the FSA's scrutiny and approval of the Prospectus, the Bank's application will undergo a final review by Nasdaq Iceland which will publish their conclusions in the European Economic Area. The Bank believes it satisfies all of the requirements for admission to trading pursuant to the requirements of Nasdaq Iceland. If admitted to trading, the Shares' ticker symbol in the trading system of the Nasdaq Iceland will be "ISB".

It is expected, although no guarantee can be given to that effect, that Nasdaq Iceland will admit the Offer Shares to trading on their regulated market. If the Offer Shares will be admitted to trading, the first day of trading in the Offer Shares will be announced by Nasdaq Iceland with a minimum of one business day's notice.

Pursuant to the above, the first expected day of trading of the Offer Shares on the regulated market of Nasdaq Iceland is 22 June 2021, subject to successful admission. The above date assumes that the Selling Shareholder does not amend the Offer Period, it does not take a longer or shorter time than the Selling Shareholder expected to process the orders, and Nasdaq Iceland responds to the Bank's applications within the Selling Shareholder's expected timeframe.

The Bank bears all cost associated with the admittance of the Offer Shares to trading. The total cost borne by the Bank is estimated to be ISK 750 million and consists of costs associated with the scrutiny and approval of the Prospectus including paid overtime to employees, the Nasdaq Iceland listing fees, fees to its advisors, along with other costs directly associated with the admittance to trading. The Selling Shareholder bears all costs associated with the marketing and selling of the Offer Shares.

Subscriptions

In respect of the offering of the Offer Shares in Iceland, applications for acquisition of Shares should be made as described below. The minimum size of orders is restricted to Offer Shares with a purchase value of ISK 50,000. There is no maximum size of orders, other than as limited by the overall size of the Offering.

Tranche A: Orders amounting to ISK 50,000 and up to ISK 75,000,000 will be categorised in Tranche A for allocation purposes.

Those orders shall be made by investors with Icelandic ID numbers. All orders for Tranche A shall be registered electronically via a subscription system, which will be accessible on the website of the Bank at www.islandsbanki.is/utbod or through the Bank's mobile application.

Tranche B: Orders over the size of ISK 75,000,000 will be categorised in Tranche B for allocation purposes.

These orders by investors with Icelandic ID numbers shall be registered electronically via a subscription system, which will be accessible on the website of the Bank at www.islandsbanki.is/utbod or through the Bank's mobile application.

Those orders from investors without Icelandic ID numbers shall be registered with the Managers and delivered to the Joint Global Coordinators. The Joint Global Coordinators reserve the right to demand sufficient proof of validation of the order.

Investors are entitled to cancel where their order was originally submitted, at any time prior to the end of the Offer Period (if applicable, as accelerated or extended).

Electronic subscription system

In order to subscribe for Offer Shares via the electronic subscription system, investors have to register to the order website or through the Bank's mobile application, through any of the following user identification numbers:

(a) electronic identification number on a smartphone;

(b) user identification number to the Bank's online bank;

(c) identification number or password requested via the order website that will be sent as a digital document to the investor's online bank, which may be in any Icelandic retail bank; or

(d) identification number and password which can be obtained from the Joint Global Coordinators by signing a witnessed application for a password or by any other method of verification which the Joint Global Coordinators consider satisfactory.

Electronic confirmation from the order website is required as valid proof of order or cancellation of order. Such confirmation will appear at the end of the registration process and in addition will be sent to the e-mail address provided by the investor.

Conditions for participation in the Offering

Investors are entitled to submit an additional order or cancel an order already submitted, in order to change an order which they have confirmed and delivered in the Offering during the Offer period. Multiple subscriptions by the same investor, in terms of national identification number, will be pooled together and treated as a single subscription for allocation purposes. All orders not cancelled during the Offer period will bind the respective investor once the Offer period terminates. Orders must be personally completed by the respective investors or by a person with the required authority or power of attorney from the investor. A person completing an order on the basis of power of attorney shall, if the power of attorney is not recognised by the principal, be deemed to have delivered the order in his/her own name. Participation in the Offering is open to persons (individuals who are 18 years of age and older, as well as legal entities) who are legally competent to manage their financial affairs and have the power to decide over their financial estate, with restrictions that may be imposed by law. As stipulated in the above conditions, if the person's estate has been declared bankrupt and such proceedings have not been completed before the end of the offer period, that person may not participate in the Offering.

Persons who are not otherwise legally competent to manage their financial affairs may not participate in the Offering.

Orders will be deemed to be a request for a service regarding execution only, as per Article 16 (4) of the Securities Transactions Act and the Managers are not obliged to assess whether participating in the Offering and buying Offer Shares in the Company is suitable for the investor and the investor does not enjoy protection in accordance with Article 16 of the Securities Transactions Act.

By placing an order investors declare that they have agreed to the terms of the Offering as set out in this Prospectus, read the information in this Prospectus, that they are aware of the conflicts of interest specified in the Prospectus and confirm that their participation in the Offering does not violate Icelandic law. Investors furthermore permit the Joint Global Coordinators to share necessary information on their respective identities and subscriptions among themselves and with the Bank, their advisors and service providers, for the sole purpose of ensuring the orderly progress, execution and closing of the Offering. Further information on the data protection policies of the Joint Global Coordinators, the Bank and their service providers may be obtained at their respective websites.

Asset Management

Certain exemptions with respect to subscriptions in the Offering are granted to financial institutions which offer asset management services pursuant to Article 3 (6.c) of the Financial Undertakings Act. These institutions may submit subscriptions on behalf of investors on a special subscription form which is obtainable from the Joint Global Coordinators. On the order form each asset management will need to provide a breakdown list of names, Icelandic ID numbers and size of each investor order. The Joint Global Coordinators reserve the right to demand a satisfactory statement from a financial institution prior to any subscription, on a form obtainable from the Joint Global Coordinators, that it has the required authority or power of attorney from the investor in accordance with authority provided in a valid asset management agreement with the investor, in addition to a statement that the payment of the purchase price will be guaranteed by the financial institution. The financial institution shall specify in such subscriptions its preference either to receive one collective invoice for the price paid by all the investor or whether each investor shall receive individual invoice. Cancellation of subscriptions submitted by financial institutions as described above must be communicated to the Joint Global Coordinators via email, ipo@islandsbanki.is.

If an asset management client has subscribed himself/herself on either of the subscription websites and an asset management service has as well submitted a subscription on his/her behalf, both subscriptions are valid. The Joint Global Coordinators will communicate to financial institutions that offer asset management the aggregate number of Offer Shares allocated to their retail investors. It is up to the financial institutions to notify their investors of their individual allocations.

Withdrawal Rights

If a significant new factor, material mistake or material inaccuracy relating to the information included in this Prospectus which may affect the assessment of the Offer Shares arises or is noted between the date of this Prospectus being approved by the FSA and the end of the Offering Period or, if applicable, the start of trading on Nasdaq Iceland, or if the Offer Price is determined above or below the Offer Price Range, or if the number of Offer Shares exceeds the maximum stated in this Prospectus, then a prospectus supplement shall be prepared, approved and published in accordance with Article 23 of the Prospectus Regulation and Article 5 of the Prospectus Act. The summary of the Prospectus shall also be supplemented as applicable.

Investors who have already agreed to purchase the Offer Shares before a supplement is published shall have the right, exercisable within two business days following the publication of a supplement, to withdraw their acceptances, provided that the significant new factor, material mistake or material inaccuracy referred to above arose or was noted before the closing of the Offering Period or delivery of the Offer Shares, whichever occurs first.

Statements contained in any supplement (or contained in any document incorporated by reference therein) shall, to the extent applicable, whether expressly, by implication or otherwise, be deemed to modify or supersede statements contained in this Prospectus. Any statement so modified or superseded shall, except as so modified or superseded, no longer constitute a part of this Prospectus. For the avoidance of doubt, references in this paragraph to any supplement being published by the Bank do not include the pricing statement.

Delivery of Offer Shares

When satisfactory payment has been received from the investor, the Offer Shares are estimated to be delivered to the investor with delivery taking place within two business days after payment has been received. Shares will be delivered electronically via Nasdaq CSD Iceland. The Bank will request that the custodian which the investor specifies in its order, will deposit the Shares in a custody account held by the investor with the custodian.

If the investor does not own a custody account with the custodian specified in the subscription, the Bank will open a custody account in the name of the investor at the Bank (and at Nasdaq CSD Iceland) in order to deposit the investor's Shares in a custody account in accordance with the above. The Bank reserves the right to collect a fee from the investor for storing the Shares as per the Bank list of fees and charges, which can be found on its website, https://www.islandsbanki.is/en/article/price-and-interest. The investor may not trade or move the Shares delivered into the custody account opened (as described above) in their name unless they have previously provided the material and information requested by the Bank to open a custody account.

PLAN OF DISTRIBUTION AND TRANSFER RESTRICTIONS

Plan of Distribution

On 7 June 2021, the Bank, the Selling Shareholder and the Managers entered into an underwriting agreement (the "**Underwriting Agreement**") with respect to the Offer Shares to be sold by the Selling Shareholder in the Offering. Subject to certain conditions set forth in the Underwriting Agreement, the Selling Shareholder has agreed to sell to the purchasers procured by the Managers or, failing which, to the Managers, and each of the Managers, severally and not jointly or jointly and severally, has agreed to procure purchasers for, or failing such procurement, each of the Managers has agreed to purchase from the Selling Shareholder, as the case may be, the percentage of the Offer Shares listed opposite such Manager's name below.

Manager	**Percentage Offered in the Offering**
Citigroup Global Markets Europe AG	36.54%
Íslandsbanki hf.(*)	—
J.P. Morgan AG	36.54%
Barclays Bank Ireland PLC	13.28%
HSBC Continental Europe	6.64%
Fossar Markaðir hf. (*)	—
Landsbankinn hf.	3.00%
Arion banki hf.	2.00%
Kvika banki hf.	2.00%
Arctica Finance hf. (*)	—
Íslenskir fjárfestar hf. (*)	—
Íslensk verðbréf hf. (*)	—
Total	**100.0%**

(*) Acting as Manager but not underwriting any Offer Shares

The Underwriting Agreement provides that the obligations of the Managers to procure purchasers for, or failing which the obligation of the Managers to purchase, the Offer Shares are subject to certain conditions and may be subject to termination by the Managers under certain customary circumstances. Should the Managers decide to terminate their several commitments, the Offering may be cancelled; if cancelled, no Offer Shares will be delivered. Pursuant to the Underwriting Agreement, the Bank will indemnify the Managers against certain liabilities and related costs or will contribute to payments that the Managers may be required to make as a result of any such liabilities.

Pursuant to the Underwriting Agreement, the Selling Shareholder will grant to the Managers an Over-Allotment Option, exercisable by the Managers on one or more occasions in whole or in part for a period of 30 days following the first day of trading in the Shares on Nasdaq Iceland, to procure purchasers for, or failing which, to purchase up to 63,636,363 additional Over-Allotment Shares (equal to up to 10% of the total number of the Existing Offer Shares to be sold in the Offering) at the Offer Price on the closing date of the Over-Allotment Option (less agreed commissions). If the Over-Allotment Option is exercised then, subject to certain conditions set forth in the Underwriting Agreement, each Manager will be obligated to procure purchasers for, or failing which, to purchase a number of Over-Allotment Shares proportionate to the respective Manager's initial percentage of Offer Shares reflected in the table above, and the Selling Shareholder will be obliged to sell the Over-Allotment Shares.

Pursuant to the Underwriting Agreement, the Joint Global Coordinators, on behalf of the Managers, will be able to borrow from the Selling Shareholder Shares representing up to a maximum of 10% of the total number of Existing Offer Shares for the purposes of, amongst other things, allowing the Stabilising Manager, on the date of respective commencement of unconditional trading in the Shares on Nasdaq Iceland, to settle over-allotments, if any, made in connection with the Offering. If the Joint Global Coordinators borrow any Shares pursuant to the terms of the Underwriting Agreement, they must return equivalent Shares to the Selling Shareholder by no later than the third business day after the date that is the 30th day after the commencement of trading of the Offer Shares.

The Managers will receive a commission of up to 2.5% (comprising a base commission of 1.5% and a discretionary commission of 1.0%) of the gross proceeds from the Offering, including the sale of any Over-

Allotment Shares. Payment of any discretionary commission will be at the sole discretion of the Selling Shareholder in consultation with the Bank.

Application has been made to begin the procedure to admit the Shares for trading on Nasdaq Iceland, and unconditional trading in the Offer Shares is expected to commence on or about 22 June 2021. The admission to listing and trading of the Shares on Nasdaq Iceland will be subject to Nasdaq Iceland's approval of the distribution of the Existing Offer Shares, amongst other things.

Investors can expect the Offer Shares to be delivered to their accounts on or about 22 June 2021. The Offer Shares will be accepted for delivery to investors' securities accounts with Nasdaq CSD Iceland, against payment in immediately available funds. All dealing in the Offer Shares prior to settlement will be for the account and at the sole risk of the parties involved. It is expected that the Offer Price will be announced no later than 15 June 2021.

There has been no public market for the Shares prior to the Offering. No assurance can be given that an active trading market will develop for the Shares or that the Shares will trade in the public market after the Offering at or above the Offer Price. See "*Risk Factors - Risks Relating to the Offering and the Offer Shares*". The market price of the Shares may fluctuate and may decline below the Offer Price. In connection with the Offering, the Managers and any affiliates acting as investors for their own account may take up the Offer Shares and in that capacity may retain, purchase or sell the Offer Shares for their own account and may offer or sell Shares other than in connection with the Offering, in accordance with applicable law in each case. The Managers do not anticipate disclosing the extent of any such investment or transaction, except in accordance with any legal or regulatory obligation to do so. No action has been or will be taken in any jurisdiction other than Iceland that would permit a public offering of the Offer Shares, or the possession, circulation or distribution of this Prospectus or any other material relating to the Bank or the Offer Shares in any jurisdiction where action for that purpose is required. Accordingly, the Offer Shares may not be offered or sold, directly or indirectly, and neither this Prospectus nor any other offering material or advertisement in connection with the Offer Shares may be distributed or published, in or from any country or jurisdiction except in compliance with any applicable rules and regulations of such country or jurisdiction. In certain jurisdictions the law restricts the distribution of this Prospectus or any offering material and the offer, sale or delivery of the Offer Shares. As a result, it is recommended that persons who may come into possession of this Prospectus or any offering material consult with their own legal advisors as to what restrictions may be applicable to them and to observe such restrictions. This Prospectus may not be used for the purpose of an offer or invitation in any circumstances in which such offer or invitation is not authorised. See "*Selling and Transfer Restrictions*".

Each of the Bank and the Selling Shareholder has agreed that it will not, without the prior written consent of the majority of the Joint Global Coordinators, such consent not to be unreasonably withheld or delayed, during the period ending 180 days after the date of admission of the Shares to listing and unconditional trading on Nasdaq Iceland: (i) directly or indirectly, issue, offer, pledge, sell, contract to sell, sell or grant any option, right, warrant or contract to purchase, exercise any option to sell, purchase any option or contract to sell, or lend or otherwise transfer or dispose of any Shares or other shares of the Bank, or any securities convertible into or exercisable or exchangeable for Shares or other shares of the Bank, or file any registration statement under the U.S. Securities Act or any similar document with any other securities regulator, stock exchange, or listing authority with respect to any of the foregoing; or (ii) enter into any swap or any other agreement or any transaction that transfers, in whole or in part, directly or indirectly, the economic consequence of ownership of any Shares or other shares of the Bank, whether any such transaction described in (i) or (ii) above is to be settled by delivery of Ordinary Shares or other securities, in cash or otherwise. The foregoing shall not apply:

> (A) with respect to the Company, (i) the sale of the Offer Shares, (ii) any Shares issued by the Bank upon the exercise of an option or warrant or the conversion of a security outstanding on the date hereof and referred to herein, (iii) any Shares issued or options to purchase Shares granted pursuant to existing employee benefit plans of the Bank referred to herein, (iv) any Shares issued pursuant to any non-employee director share plan or dividend reinvestment plan referred to herein, provided that any transferees will be subject to equivalent lock-up restrictions, (v) transfers involving affiliates (as long as recipients sign equivalent lock-up undertakings), (vi) any disposals in the context of a takeover offer or scheme or share buybacks, (vii) any other situation in which applicable law requires the disapplication of restrictions set forth in the first sentence of this paragraph, (viii) any transactions conducted by the Bank pursuant to any third party client orders to buy or sell Shares or any options, warrants or any other rights in respect of Shares; (ix) any disposal of, or other transaction in Shares

conducted by or on behalf of funds administered by Islandssjóðir hf.; (x) the issuance of any additional tier one debt instruments or securities substantially similar to additional tier one debt instruments; (xi) any transactions made pursuant to any offer by the Bank to purchase its own shares which is made on identical terms (subject to any differences or omissions arising as a result of overseas securities laws) to all holders of Shares and otherwise complies with applicable laws and regulations;

(B) with respect to the Selling Shareholder, (i) the sale of the Offer Shares, (ii) to the acceptance of an offer for the entire issued Shares of the Bank or to the giving or an irrevocable undertaking to accept an offer for the entire issued Shares of the Bank; (iii) any direct or indirect, offer, pledge, sale, contract to sell, sale or grant of any option, right, warrant or contract to purchase, exercise of any option to sell, purchase of any option or contract to sell, or loan or other transfer or disposal of rights to new Shares to be issued by way of rights issue to fund its take-up of the balance of its rights or (iv) such Shares held by the Selling Shareholder as may be lent and transferred by the Selling Shareholder to the Managers pursuant to the terms of the Underwriting Agreement.

Following consultation with the Managers, the Selling Shareholder will determine the Offer Price on the basis of a number of factors, including the following:

(a) the orders, in terms of price and quantity, received from potential institutional and retail investors;

(b) the prevailing market conditions;

(c) the criteria provided in Act No. 155/2012, Act No. 88/2019, the Minister's Decision and the Government's Ownership Policy;

(d) the Bank's historical, operational and financial performance;

(e) estimates of the Bank's business potential and earning prospects; and

(f) the market valuation of publicly traded common stock of comparable companies.

The Offer Price is subject to the final approval by the Minister.

The Managers and their affiliates have engaged in transactions with and performed various investment banking, commercial banking and other services for the Bank, the Selling Shareholder and their respective subsidiaries and affiliates in the past and may do so from time to time in the future and may be paid fees in connection with such services from time to time. Nevertheless, all services provided by the Managers, including in connection with the Offering, have been provided as an independent contractor and not as a fiduciary to the Bank or the Selling Shareholder. See "*Presentation of Financial and Other Information - Potential Conflict of Interest*". In connection with the Offering, and to the extent permitted by law and regulation to which they are subject, each of the Managers or their affiliates may take up a portion of the Offer Shares in the Offering as a principal position and in that capacity may retain, purchase or sell for its own account such securities and any Offer Shares or related investments and may offer or sell such Offer Shares or other investments otherwise than in connection with the Offering. Accordingly, references in this Prospectus to Offer Shares being offered or placed should be read as including any offering or placement of Offer Shares to any of the Managers or any of their respective affiliates acting in such capacity. In addition, certain of the Managers or their affiliates may enter into financing arrangements (including swaps, warrants or contracts for differences) with investors in connection with which such Managers (or their affiliates) may from time to time acquire, hold or dispose of Offer Shares. None of the Managers intend to disclose the extent of any such investment or transactions otherwise than in accordance with any legal or regulatory obligation to do so.

In connection with the Offering and to the degree permitted by applicable law, Landsbankinn hf., as Stabilising Manager, or any of its agents, on behalf of the Managers, may (but will be under no obligation to), engage in transactions that stabilise, maintain or otherwise affect the price of the Shares for up to 30 days from the commencement of trading on Nasdaq Iceland. Specifically, the Managers may over-allot Shares or effect other transactions with a view to supporting the market price of the Shares at a higher level than that which might otherwise prevail in the open market. The Stabilising Manager and its agents are not required to enter into such transactions and such transactions may be effected on any securities market, over-the-counter market, stock exchange or otherwise and may be undertaken at any time during the period commencing on the first day of trading in the Shares on Nasdaq Iceland and ending no later than 30 calendar days thereafter. However, there will be no obligation on the Stabilising Manager or any of its agents to effect stabilising transactions, and no assurance can be given that stabilising transactions will be undertaken. Such stabilisation, if commenced, may be discontinued at any time without prior notice. In no event will measures be taken to stabilise the market price of the Shares above the Offer Price. The Stabilising Manager will disclose information on stabilisation transactions under the Offering as required by the Securities Transaction Act and Regulation No. 630/2005 on Insider Information and Market Abuse, as amended.

The Bank has entered into binding heads of terms for a market making contract with Arion Bank (the "**Market Maker**"), subject to the Market Maker receiving allocation in the Offering. With the agreement the Market Maker undertakes to place bids and offers for a minimum number of Shares (minimum number of Shares equalling a value of ISK 25,000,000 on the first day of the agreement) with limits on the maximum spread of 1.5%. If the price of the Shares changes by 5% or more on the same trading day, the Market Maker is permitted to double the maximum spread to 3% for the remainder of that day. The contract will become effective after the expiry of the stabilisation period in respect of the Offering and is valid for an indefinite period of time but is terminable by either party with one month's notice.

Cornerstone Investments

Each of (i) funds managed and advised by Capital World Investors; (ii) RWC Asset Management LLP; (iii) Gildi-lífeyrissjóður; and (iv) Lífeyrissjóður verzlunarmanna, as Cornerstone Investors, has committed to acquire at the Offer Price (and at any such price throughout the Offer Price Range set forth above) 76,923,077, 30,769,231, 46,153,846 and 46,153,846 Offer Shares, respectively. The Cornerstone Investors' undertakings are conditional on, among other things, commencement of unconditional trading of the Offer Shares occurring no later than 31 July 2021. If such conditions are not satisfied, the Cornerstone Investors will not be required to acquire any Offer Shares. In the case of the investment of funds managed and advised by Capital World Investors, settlement of such investment will occur on a closing date to be mutually agreed between the parties, in consultation with the Bank and the Joint Global Coordinators. In addition, the Cornerstone Investors' undertakings have not been secured through a bank guarantee, blocked funds, pledge of collateral or similar arrangement. The Cornerstone Investors will not be subject to a lock-up in respect of their allocations.

Selling and Transfer Restrictions

No action has been or will be taken in any jurisdiction other than Iceland that would permit a public offering of the Offer Shares, or the possession, circulation or distribution of this Prospectus or any other material relating to the Bank or the Offer Shares in any jurisdiction where action for that purpose is required. In certain jurisdictions the distribution of this Prospectus and the offer of the Offer Shares may be restricted by law. Persons into whose possession this Prospectus comes should apprise themselves of and observe any such restrictions, including those in the paragraphs that follow. Any failure to comply with these restrictions may constitute a violation of the securities laws of any such jurisdictions.

United States

The Offer Shares have not been and will not be registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States for offer or sale as part of their distribution and may not be offered or sold within the United States unless the Offer Shares are registered under the U.S. Securities Act or an exemption from the registration requirements of the U.S. Securities Act is available. In the United States, the Offer Shares will be sold only to persons reasonably believed to be. All offers and sales of the Offer Shares outside the United States will be made in compliance with Regulation S under the U.S. Securities Act and in accordance with applicable law.

In addition, until the end of the 40th calendar day after commencement of the Offering, an offer or sale of the Offer Shares within the United States by a dealer that is not participating in the Offering may violate the registration requirements of the U.S. Securities Act if such offer or sale is made otherwise than in accordance with Rule 144A under the U.S. Securities Act. The Offering of the Offer Shares is being made in the United States through U.S. broker-dealer affiliates of the Managers.

Notice to U.S. Investors

Each purchaser of the Offer Shares within the United States will be deemed to have represented and agreed as follows:

(a) the purchaser is authorised to consummate the purchase of the Offer Shares in compliance with all applicable laws and regulations;

(b) the purchaser: (i) is, and the time of its purchase of any Offer Shares will be, a QIB or a broker-dealer acting for the account of a QIB and (ii) is acquiring the Offer Shares for its own account or for the accounts of one or more QIBs for which it is acting as duly authorised fiduciary or agent with sole investment discretion with respect to each such account and with full authority to make the acknowledgments, representations and agreements herein with respect to each such account (in which case, it hereby makes such acknowledgements, representations and agreements on behalf of such QIBs as well), in each case, for investment and not with a view to any resale or distribution (within the meaning of the United States securities laws) of any such Offer Shares;

(c) the purchaser understands and acknowledges that the Offer Shares have not been and will not be registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and are being offered in the United States only in transactions not involving any public offering in the United States within the meaning of the U.S. Securities Act or which are exempt from the registration requirements of the U.S. Securities Act;

(d) the purchaser acknowledges that sellers of the Offer Shares may be relying on the exemption from the registration requirements of Section 5 of the U.S. Securities Act provided by Rule 144A thereunder and that the Offer Shares may not be offered, sold, pledged or otherwise transferred, directly or indirectly, other than in accordance with paragraph (F) below;

(e) the purchaser and each other QIB, if any, for whose account it is acquiring the Offer Shares, in the normal course of business, invests in or purchases securities similar to the securities offered hereby, has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of purchasing any Offer Shares for an indefinite period of time and is able to bear such risk for an indefinite period;

(f) the purchaser has: (i) conducted its own investigation with respect to the Bank and the Offer Shares; (ii) received all information that it believes is necessary or appropriate in connection with an investment in the Offer Shares; and (iii) made its own assessment and has satisfied itself concerning the relevant tax, legal and other economic considerations relevant to an investment in the Offer Shares;

(g) the purchaser understands and agrees that the Offer Shares may be offered, sold, delivered, hypothecated, pledged or otherwise transferred only (i) pursuant to an effective registration statement under the U.S. Securities Act, (ii) to a person whom the seller and any person acting on its behalf reasonably believe is a QIB purchasing for its own account or for the account of a QIB in a transaction meeting the requirements of Rule 144A, (iii) outside the United States, in an "offshore transaction" in compliance with Regulation S (and not in a pre-arranged transaction resulting in the resale of such Offer Shares into the United States) or (iv) in accordance with Rule 144 under the U.S. Securities Act, and, in each case, in accordance with all applicable securities laws of the United States, any state or territory thereof and any other relevant jurisdiction. The purchasers understands that the Offer Shares are "restricted securities" within the meaning of Rule 144(a)(3) and that no representation is made as to the availability of the exemption provided by Rule 144 for resales of any Offer Shares;

(h) the purchaser understands that for as the duration of the time that the Offer Shares are "restricted securities" within the meaning of the U.S. federal securities laws, no such Offer Shares may be deposited into any American depositary receipt facility established or maintained by a depositary bank, other than a Rule 144A restricted depositary receipt facility, and that such Offer Shares will not settle or trade through the facilities of The Depositary Trust Company or any other United States clearing system;

(i) none of the Selling Shareholder, the Managers or the Bank will recognise any offer, sale, pledge, delivery, hypothecation or other transfer of the Offer Shares made other than in compliance with the above-stated restrictions;

(j) the purchaser has received a copy of this Prospectus and has had access to such financial and other information relating to the Bank as it considers necessary in connection with making its own investment decision to purchase the Offer Shares. The purchaser acknowledges that none of the Selling Shareholder, the Bank, the Managers or any of their respective representatives has made any representation to it with respect to the Bank or the allocation, offering or sale of any Offer Shares other than as set forth in this Prospectus, which has been delivered to it and upon which it is solely relying in making its investment decision with respect to the Offer Shares;

(k) the purchaser also acknowledges that it has made its own assessment regarding the U.S. federal tax consequences of an investment in the Offer Shares; and

(l) the purchaser understands that these representations and undertakings are required in connection with the securities laws of the United States and acknowledges that the Bank, the Managers and their respective affiliates will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements. The purchaser undertakes to notify the Selling Shareholder, the Bank and the Managers promptly if, at any time prior to the purchase of the Offer Shares, any of the foregoing ceases to be true.

Notice to Investors Outside the United States

Each purchaser of the Offer Shares outside the United States will be deemed to have represented and agreed that it has received a copy of this Prospectus and such other information as it considers necessary to make an informed investment decision and as follows:

(a) the purchaser is authorised to consummate the purchase of the Offer Shares in compliance with all applicable laws and regulations;

(b) the purchaser understands and acknowledges that the Offer Shares have not been, and will not be, registered under the U.S. Securities Act or with any securities regulatory authority of any state of the United States and are being offered in the United States only in transactions not involving any public offering in the United States within the meaning of the U.S. Securities Act or which are exempt from the registration requirements of the U.S. Securities Act;

(c) the purchaser (and the person, if any, for whose account or benefit the purchaser is acquiring the Offer Shares) was located outside the United States at the time the buy order for the Offer Shares was originated and continues to be located outside the United States and has not purchased the Offer Shares for the account or benefit of any person in the United States or entered into any arrangement for the transfer of the Offer Shares or any economic interest therein to any person in the United States;

(d) the purchaser is not an affiliate of the Bank or a person acting on behalf of such affiliate;

(e) it has not been offered the Offer Shares by means of any "directed selling efforts" as defined in Regulation S;

(f) the purchaser understands the restrictions on the offer and sale of the Offer Shares pursuant to Regulation S described in this Prospectus;

(g) the purchaser has (i) conducted its own investigation in relation to the Bank and the Offer Shares, (ii) received all information that it believes is necessary or appropriate in connection with an investment in the Offer Shares, and (iii) made its own assessment and has satisfied itself concerning the relevant tax, legal and other economic considerations relevant to an investment in the Offer Shares;

(h) none of the Selling Shareholder, the Managers or the Bank will recognise any offer, sale, pledge, delivery, hypothecation or other transfer of the Offer Shares made other than in compliance with the above-stated restrictions;

(i) if it is acquiring any of the Offer Shares as a fiduciary or agent for one or more accounts, the purchaser represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of such account;

(j) the purchaser has received a copy of this Prospectus and has had access to such financial and other information concerning the Bank as it deems necessary in connection with making its own investment decision to purchase the Offer Shares. The purchaser acknowledges that none of the Selling Shareholder, the Bank, the Managers or any of their respective representatives has made any representation to it with respect to the Bank or the allocation, offering or sale of any Offer Shares other than as pursuant to this Prospectus, which has been delivered to it and upon which it is solely relying in making its investment decision regarding the Offer Shares; and

(k) the purchaser acknowledges that the Selling Shareholder, the Bank, the Managers and their respective affiliates will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements and undertakes promptly to notify the Bank and the Managers if, at any time prior to the purchase of the Offer Shares, any of the foregoing ceases to be true.

European Economic Area

In relation to each Relevant Member State (including Iceland), no Offer Shares have been offered or will be offered pursuant to the offer to the public in such Relevant Member State prior to the publication of a prospectus in relation to the Offer Shares which has been approved by the competent authority in such Relevant Member State or, where appropriate, approved in another Relevant Member State, all in accordance with the Prospectus Regulation, saving that offers of the Offer Shares may be made to the public in such Relevant Member State at any time under the following exemptions under the Prospectus Regulation, if they are implemented in such Relevant Member State:

(a) to any legal entity that is a Qualified Investor as defined under Article 2 of the Prospectus Regulation;

(b) to fewer than 150 natural or legal persons in a Relevant Member State (other than Qualified Investors within the meaning of the Prospectus Regulation) subject to obtaining the prior consent of the Joint Global Coordinators; or

(c) in any other circumstances which do not require the publication by the Company of a prospectus pursuant to Article 1(4) of the Prospectus Regulation; *provided that* no such offer of the Offer Shares will result in a requirement for the publication of a prospectus pursuant to Article 3 of the Prospectus Regulation or of a supplement to a prospectus pursuant to Article 23 of the Prospectus Regulation. Each person in a Relevant Member State who acquires any Offer Shares or to whom any offer is made under the Offering will be deemed to have represented, acknowledged and agreed that it is a "qualified investor" within the meaning of Article 2 of the Prospectus Regulation.

For the purposes of this provision, (a) the phrase an "**offer to the public**" in relation to any Offer Shares in any Relevant Member State (including Iceland) means the communication in any form and by any means of sufficient information on the terms of the Offering and the Offer Shares so as to enable an investor to decide to purchase the Offer Shares, as the same may be varied in that Relevant Member State by any measure implementing the Prospectus Regulation in such Relevant Member State, (b) the phrase "**Prospectus Regulation**" means Regulation (EU) No 2017/1129 of the European Parliament.

United Kingdom

No Offer Shares have been offered or will be offered pursuant to the Offering to the public in the United Kingdom prior to the publication of a prospectus in relation to the Offer Shares which has been approved by the FCA, except that Offer Shares may be offered to the public at any time:

(a) to any legal entity which is a qualified investor as defined under Article 2 of the UK Prospectus Regulation;

(b) to fewer than 150 natural or legal persons (other than qualified investors as defined under Article 2 of the UK Prospectus Regulation); or

(c) in any other circumstances falling within section 86 of FSMA,

provided that no such offer of Offer Shares shall result in a requirement for the publication of a prospectus pursuant to section 85 of the FSMA or supplement a prospectus pursuant to Article 23 of the UK Prospectus Regulation. Each person in the United Kingdom who acquires any Offer Shares or to whom any offer is made under the Offering will be deemed to have represented, acknowledged and agreed that it is a "qualified investor" within the meaning of Article 2 of the UK Prospectus Regulation.

For these purposes, the expression "an offer to the public" in relation to any offer of Offer Shares in the United Kingdom means a communication in any form and by any means presenting sufficient information on the terms of the offer and any Offer Shares to be offered so as to enable an investor to decide to purchase or subscribe for the Offer Shares and the term the "UK Prospectus Regulation" means Regulation (EU) 2017/1129 (as amended), as it form part of domestic law by virtue of the European Union (Withdrawal) Act 2018.

This document is being distributed to, and is directed only at (i) persons in the United Kingdom who are "qualified investors" (within the meaning of Article 2 of the UK Prospectus Regulation) and (a) who have professional experience in matters relating to investments falling within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, as amended (the "FPO"); and/or (b) who are high net worth entities falling within Article 49(2)(a) to (d) of the FPO; and (ii) other persons to whom it may otherwise be lawfully distributed (each a "relevant person"). Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with such persons. Persons who are not relevant persons should not rely on or act upon this document.

Certain Restricted Jurisdictions

NO OFFER SHARES HAVE BEEN OFFERED, SOLD, TAKEN UP, DELIVERED OR TRANSFERRED OR WILL BE OFFERED, SOLD, TAKEN UP, DELIVERED OR TRANSFERRED IN, INTO OR FROM AUSTRALIA, CANADA, THE REPUBLIC OF SOUTH AFRICA OR SWITZERLAND SUBJECT TO CERTAIN EXEMPTIONS UNDER THE RELEVANT SECURITIES LAWS OF AUSTRALIA, CANADA, THE REPUBLIC OF SOUTH AFRICA OR SWITZERLAND.

DEFINITIONS AND GLOSSARY

"**ABN AMRO**" means ABN AMRO Bank N.V., financial advisor to the Bank;

"**Admission**" means admission to listing and trading on Nasdaq Iceland of the Shares;

"**ALCO**" means the Bank's Asset and Liability Committee;

"**AML Act**" means Act No. 140/2018 on Measures against Money Laundering and the Financing of Terrorist Activities, as amended;

"**Annual Accounts Act**" means the requirements set forth in Act No. 3/2006 on Annual Accounts, as amended;

"**Annual Financial Statements**" means the Bank's audited consolidated financial statements for the financial years ended 31 December 2018 to 2020;

"**ARC**" means the Bank's all risk committee;

"**Arion Bank**" means Arion Banki hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires;

"**Articles of Association**" means the articles of association for Íslandsbanki hf.;

"**Bank**" or "**Company**" means Íslandsbanki hf., a public limited company established under the laws of the Republic of Iceland, with registration number 491008-0160 and LEI code 549300PZMFIQR79Q0T97, having its registered office at Hagasmári 3, 201 Kópavogur, Iceland;

"**Bank Levy**" or "**Bank tax**" means the annual levy which, pursuant to the Parliament of Iceland passed Act No. 155/2010 on Special Tax on Financial Institutions, certain types of financial institutions, including the Bank, are required to pay;

"**Board of Directors**" means the board of directors of the Bank;

"**Board Rules**" means the Rules of Procedure of the Board of Directors adopted in accordance with Article 70 of the Act on Public Limited Companies No. 2/1995 and Article 54 of the Financial Undertakings Act;

"**Borgun**" means Borgun hf., currently SaltPay IIB hf.;

"**BRRD**" means Directive 2014/59/EU;

"**Capital Controls**" means the capital controls introduced by the Parliament of Iceland in November 2008 with the view of stabilising the foreign exchange rate of Icelandic Króna and currently set out in the Foreign Exchange Act, which were largely lifted as at March 2017;

"**Capital Requirements Directives**" means directive 2006/48/EC and directive 2006/49/EC;

"**Central Bank of Iceland**" means the Central Bank of Iceland (*Seðlabanki Íslands*);

"**Central Securities Depositories Act**" means the Act No. 7/2020 on Central Securities Depositories, Settlement and Electronic Registration of Financial Instruments, as amended;

"**Co-Lead Managers**" means Arctica Finance hf., Íslenskir fjárfestar hf. and Íslensk verðbréf hf.;

"**Commission Delegated Regulation (EU) 2019/980**" means Commission Delegated Regulation (EU) 2019/980 of 14 March 2019, supplementing the Prospectus Regulation;

"**Competition Act**" means Competition Act No. 44/2005, as amended;

"**Consumer Agency**" means the Icelandic Consumer Agency;

"**Cornerstone Investors**" means (i) funds managed and advised by Capital World Investors; (ii) RWC Asset Management LLP; (iii) Gildi-lífeyrissjóður; and (iv) Lífeyrissjóður verzlunarmanna;

"**Corporate Governance Guidelines**" means Fifth edition of the Icelandic Guidelines on Corporate Governance issued by the Iceland Chamber of Commerce, SA—Business Iceland and Nasdaq Iceland, to be replaced by the Updated Corporate Governance Guidelines on 1 July 2021;

"**COVID-19**" means the outbreak of a strain of novel coronavirus disease which was declared a global pandemic by the World Health Organization on 11 March 2020;

"**CRD IV Directive**" or "**CRD IV**" means Directive 2013/36/EU;

"**CRD V**" means CRD IV (Directive (EU) 2019/878;

"**CRR**" means Regulation (EU) 575/2013;

"**CRR II**" means CRR Regulation (EU) 2019/876;

"**CSDR**" means Regulation (EU) 909/2014 on improving securities settlement in the European Union and on central securities depositories;

"**CSMAD**" means Directive 2014/57/EU on criminal sanctions for insider dealing and market manipulation;

"**Data Protection Act**" means Act No. 90/2018 on Protection of Privacy and Processing of Personal Data, as amended;

"**Deposit Guarantees Act**" means Act No. 98/1999 on Deposit Guarantees and Investor-Compensation Scheme, as amended;

"**Depositors' and Investors' Guarantee Fund**" means the fund established in Iceland pursuant to the provisions of the Deposit Guarantees Act and which guarantees a minimum level of protection to depositors in commercial and savings banks and to customers of companies engaging in securities trading pursuant to the relevant laws;

"**Disclosure Requirements Act**" means Act No. 20/2021 on Disclosure and Information requirements of Issuers of Securities and Major Holding Notifications, as amended;

"**DPA**" means the Icelandic Data Protection Authority;

"**EBA**" means the European Banking Authority;

"**EFTA Court**" means the Court of Justice of the EEA EFTA states;

"**Eignarhlutir ehf.**" means the private limited company Eignarhlutir ehf., wholly owned by the Treasury of Iceland, reg. no. 4911060180, Lindargötu Arnarhvoli, 101 Reykjavík, owner of 2,000,000 Shares;

"**Electronic Money Directive**" means Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions;

"**EMIR**" means Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories;

"**EU Interchange Fee Regulation**" means Regulation (EU) 2015/751;

"**European Economic Area**" or "**EEA**" means the Member States of the European Union including Iceland, Liechtenstein and Norway;

"**European Financial Supervision System Act**" means the Act No. 24/2017 on European Financial Market Supervision System, as amended;

"**Executive Committee**" means the executive committee of the Bank;

"**Existing Offer Shares**" means ordinary shares in the form of existing Shares;

"**FATCA**" means the US Foreign Account Tax Compliance Act;

"**Financial Activities Supervision Act**" means Act No. 87/1998 on Official Supervision of Financial Activities;

"**Financial Activity Tax**" means the additional 5.5% tax levied on all remuneration paid to employees which, pursuant to the Parliament of Iceland enacted Act No. 165/2011 on Financial Activities Tax, requires certain types of financial institutions, including the Bank, to pay;

"**Financial Advisors**" means ABN AMRO and STJ;

"**Financial Undertakings Act**" means Act No. 161/2002 on Financial Undertakings, as amended;

"**First Banking Consolidation Directive**" means Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions;

"**Foreign Exchange Act**" means Act No. 87/1992 on Foreign Exchange, as amended;

"**Fourth Money Laundering Directive**" means Directive (EU) 2015/849/EU;

"**FSA**" means the Icelandic Financial Supervisory Authority which was merged with the Central Bank of Iceland in 2020;

"**GDPR**" means the General Data Protection Regulation (EU) 2016/679;

"**Glitnir bank hf.**" or "**Glitnir**" means Glitnir Bank hf., the assets and certain liabilities (deposits) of which were transferred to the Bank following the financial crisis in 2008;

"**GMTN programme**" means Global Medium-Term Note programme;

"**Government's Ownership Policy**" means the government's ownership policy for financial undertakings dated in February 2020;

"**Grey List**" means the Financial Action Task Force's list of countries that are considered to be a safe haven for supporting terror funding and money laundering;

"**Group**" means the Bank and all its consolidated subsidiaries;

"**Housing and Construction Authority**" means *Húsnæðis- og mannvirkjastofnun/ÍLS sjóður* (formerly known as the Housing Financing Fund);

"**IAS 24**" means International Accounting Standard 24 – Related Party Disclosures;

"**IC**" means the Bank's investment committee;

"**ICA**" means the Icelandic Competition Authority (*Samkeppniseftirlitið*);

"**ICAAP**" means Internal Capital Adequacy Assessment Process;

"**Iceland**" means the country of the Republic of Iceland;

"**Iceland Funds**" means Íslandssjóðir hf.;

"**Icelandic Investors**" means Íslenskir fjárfestar hf.;

"**Icelandic Króna**" or "**ISK**" means the legal currency of Iceland;

"**Iceland SIF**" means Iceland Sustainable Investment Forum;

"**IFRS**" means the International Financial Reporting Standards as adopted by the European Union;

"**IFRS 9**" means International Financial Reporting Standard No. 9 on Financial Instruments;

"**INAO**" means the Icelandic National Audit Office;

"**Income Tax Act**" means Income Tax Act No. 90/2003, as amended;

"**Insurance Activities Act**" means Act No. 100/2016 on Insurance Activities, as amended;

"**Interest Act**" means Act No. 38/2001 on Interest and Indexation, as amended;

"**IRS**" means the Internal Revenue Service of the United States;

"**ÍV**" means Íslensk verðbréf hf.;

"**Joint Bookrunners**" means Citigroup Global Markets Europe AG, Íslandsbanki hf., J.P. Morgan AG, Barclays Bank Ireland PLC, HSBC Continental Europe, Fossar Markaðir hf. and Landsbankinn;

"**Joint Global Coordinators**" means Citigroup Global Markets Europe AG, Íslandsbanki hf. and J.P. Morgan AG;

"**Joint Lead Managers**" means Arion Bank and Kvika;

"**Króna Asset Acts**" means Act No. 37/2016 on the Treatment of Króna-denominated Assets Subject to Special Restrictions, as amended;

"**Kvika**" means Kvika banki hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires;

"**Landsbankinn**" means Landsbankinn hf., a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires;

"**LCR**" means liquidity coverage ratio;

"**LCR Rules**" means the Rules on LCR No. 266/2017 effective from 31 March 2017 as amended by Rules No. 1170/2019 and Rules No. 1399/2020;

"**LTV**" means loan-to-value ratio;

"**Lugano Convention**" means the Lugano Convention on jurisdiction and the recognition and enforcement of judgements in civil and commercial matters;

"**Managers**" means the Co-Lead Managers and the Joint Lead Managers together with the Joint Bookrunners;

"**MAR**" means Regulation (EU) 596/2014 on market abuse;

"**Market Abuse Directive**" means Directive 2003/6/EC;

"**MCR**" means Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property;

"**MiFID**" means Directive 2004/39/EC on Markets in Financial Instruments;

"**MiFID 2**" means Directive 2014/65/EU on markets in financial instruments, as amended;

"**MiFID 2 Product Governance Requirements**" means Articles 9 and 10 of Commission Delegated Directive (EU) 2017/593 supplementing MiFID 2 and any applicable local implementing measures;

"**MiFIR**" means Regulation (EU) 600/2014 on Markets in Financial Instruments

"**Minister**" means the Icelandic Minister of Finance and Economic Affairs;

"**Minister's Decision**" means the decision made on 29 January 2021 to initiate a sale process for certain of the Selling Shareholder's Shares in the Bank based on a proposal made by the Selling Shareholder on 17 December 2020 announced by the Ministry of Finance;

"**Ministry of Finance**" means the Ministry of Finance and Economic Affairs;

"**Nasdaq CSD SE**" means Nasdaq CSD SE, which operates securities settlement systems in Iceland, Latvia, Estonia and Lithuania;

"**Nasdaq CSD Iceland**" means the Icelandic branch of Nasdaq CSD SE, having its registered office at Laugavegur 182, 105 Reykjavík, Iceland;

"**Nasdaq Iceland**" means Nasdaq Iceland, the stock exchange in Iceland;

"**Nasdaq Iceland hf.**" means Nasdaq Iceland hf. (Kauphöll Íslands hf.), the operating entity of Nasdaq Iceland;

"**Nasdaq Iceland Rules**" means the Nasdaq Nordic Main Market Rulebook for Issuers of Shares, effective from 1 February 2021 (harmonised part), setting forth listing requirements and disclosure rules for, *inter alia*, companies listed on Nasdaq Iceland;

"**National Registry**" means Þjóðskrá Íslands, the National Registry of Iceland;

"**Non-IFRS Information**" means certain financial measures that are not defined or recognised under IFRS, comprising liquidity coverage ratio, net stable funding ratio, CET1 ratio, loan-to-deposit ratio, REA density, net interest margin, return on equity, cost-to-income ratio, total capital ratio, deposit yield, loan-to-value on mortgages to individuals, over-collateralisation, leverage ratio, dividend ratio, cost of risk, asset encumbrance ratio, long term annual credit loss;

"**Nordic Judgement Conventions**" means the convention on the recognition and enforcement of judgements and a convention on the recognition and enforcement of judgements in civil matters, both of which Iceland, Denmark Finland, Norway and Sweden, are a party to;

"**Nordic Tax Treaty**" means the Convention Between the Nordic Countries for the Avoidance of Double Taxation;

"**NSFR**" means net stable funding ratio;

"**OECD Common Reporting Standards**" or "**CRS**" means the Organisation for Economic Co-operation and Development Common Reporting Standards;

"**Offering**" means Offering of the Offer Shares, consisting of (a) a public offering of the Offer Shares in Iceland to retail and institutional investors in accordance with the Prospectus Act and (b) an institutional offer of the Offer Shares: (i) to certain institutional investors outside the United States in reliance on Regulation S and in accordance with locally applicable laws and regulations; and (ii) in the United States, only to QIBs in reliance on Rule 144A or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act;

"**Offering Period**" means the period during which the Offering is open, expected to be from 09:00 GMT on 7 June 2021 to 12:00 GMT on 15 June 2021;

"**Offer Price**" means the price at which the Offer Shares will be sold;

"**Offer Price Range**" means the price range of the Offer Shares;

"**Offer Shares**" means the initial offering of ordinary shares in the form of existing Shares;

"**Offshore Króna Assets**" means certain assets denominated in Icelandic Króna as defined in item 1 of Article 2(1) of the Króna Asset Act;

"**OSC**" means the Bank's operations and security committee;

"**Over-Allotment Option**" means Option granted to the Managers by the Selling Shareholders pursuant to which the Managers may require the Selling Shareholders to sell at the Offer Price the Over-Allotment Shares;

"**Over-Allotment Shares**" means up to 63,636,363 additional shares (either in the form of Existing Offer Shares), comprising up to 10% of the total number of Existing Offer Shares sold in the Offering;

"**Payment Services Act**" means Act No. 120/2011 on Payment Services, as amended;

"**Payment Services Directive**" means Directive 2007/64/EC on payment services;

"**Payment Services Directive 2**" means Directive (EU) 2015/2366;

"**PFIC**" means passive foreign investment company;

"**PRIIPs Regulation**" means Regulation (EU) 1286/2014 on key information documents for packaged retail and insurance-based investment products;

"**Private Limited Company Act**" means Act No. 138/1994 respecting Private Limited Companies, as amended, under which the Bank was established as a public limited company;

"**Prospectus**" means Offering document pursuant to which the Shares are offered and sold in the Offering;

"**Prospectus Act**" means Act No. 14/2020 on Prospectus for Public Offering or Admission to Trading on a Regulated Market, as amended;

"**Prospectus Regulation**" means Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 and any applicable amendments;

"**Public Limited Companies Act**" means Act No. 2/1995 respecting Public Limited Companies, as amended, under which the Bank was established as a public limited company;

"**QIB**" means qualified institutional buyers as defined in Rule 144A under the U.S. Securities Act or pursuant to another exemption from, or in a transaction not subject to, the registration requirements of the U.S. Securities Act and applicable state securities laws;

"**RB**" means Reiknistofa bankanna hf., (Icelandic Banks' Data Centre) a public limited company established under the laws of the Republic of Iceland, and its consolidated subsidiaries, unless the context otherwise requires;

"**Recovery and Resolution Act**" means Act No. 70/2020 on Recovery and Resolution of Credit Institutions and Investment Firms, as amended;

"**Regulation S**" means Regulation S under the U.S. Securities Act;

"**Relevant Member State**" means any member state of the EEA that has implemented the Prospectus Regulation;

"**ROE**" means return on equity;

"**Rule 144A**" means Rule 144A under the U.S. Securities Act;

"**SC**" means the Bank's committee for sustainability;

"**SCC**" means the Bank's senior credit committee;

"**Securities Transactions Act**" means the Act No. 108/2007 on Securities Transactions, as amended;

"**Selling Shareholder**" means Icelandic State Financial Investments on behalf of the Treasury of Iceland, Borgartún 3, 105 Reykjavík, Iceland;

"**Settlement**" means delivery of, the Offer Shares, which occurs after the payment therefor;

"**Settlement Date**" means the date on which Settlement takes place;

"**Shareholder**" means a holder of Ordinary Shares;

"**Shares**" means ordinary shares of the Bank, each with a par value of ISK 5.00;

"**SME**" means small-to medium-sized enterprise customers of the Bank and/or its subsidiaries;

"**Special Financial Activity Tax**" means an additional tax of 6.0% which the Bank is subject to under the Income Tax Act as a financial institution in respect of taxable profit exceeding ISK 1.0 billion irrespective of joint taxation or carry-forward losses;

"**SREP**" means the Supervisory Review and Evaluation Process conducted by the Central Bank of Iceland;

"**SSR**" means Regulation (EU) 236/2012 on short selling and certain aspects of credit default swaps;

"**Stabilising Manager**" means Landsbankinn hf., who may over-allot Shares or effect other transactions with a view to supporting the market price of the Shares at a higher level than that which might otherwise prevail in the open market;

"**Stage 1**" means the definition of Stage 1 as set out in note 67.4 of the 2020 Annual Financial Statements;

"**Stage 2**" means the definition of Stage 2 as set out in note 67.4 of the 2020 Annual Financial Statements;

"**Stage 3**" means the definition of Stage 3 as set out in note 67.4 of the 2020 Annual Financial Statements;

"**STJ**" means STJ Advisors Group Limited, financial advisor to the Selling Shareholder;

"**Stock Exchanges Act**" means Act No. 110/2007 on Stock Exchanges, as amended;

"**Surveillance and Court Agreement**" means Protocol 2 of the Agreement between the EEA EFTA states on the Establishment of a Surveillance Authority and a Court of Justice;

"**Target Market Assessment**" means all distribution channels permitted by MiFID 2;

"**The Code**" means U.S. Internal Revenue Code of 1986, as amended;

"**Transparency Directive**" means Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers with securities admitted to trading on a regulated market;

"**Treasure Regulations**" means treasury regulations issued under the Code;

"**Underwriting Agreement**" means the underwriting agreement entered into by Bank, the Selling Shareholders and the Managers with respect to the Offering;

"**United States**" or "**U.S.**" means the country of the United States of America;

"**Updated Corporate Governance Guidelines**" means Sixth edition of the Icelandic Guidelines on Corporate Governance issued by the Iceland Chamber of Commerce, SA—Business Iceland and Nasdaq Iceland, which will enter into force on 1 July 2021 and replace the fifth edition of the Corporate Governance Guidelines;

"**U.S. – Iceland Treaty**" means Convention and Protocol Between the United States of America and Iceland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; and

"**U.S. Securities Act of 1933**" or "**U.S. Securities Act**" means U.S. Securities Act of 1933, as amended.

CONSOLIDATED FINANCIAL STATEMENTS

Íslandsbanki

Condensed Consolidated Interim Financial Statements

First quarter 2021

These are the condensed consolidated interim financial statements for the period 1 January to 31 March 2021 (“the interim financial statements”) of Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) and its subsidiaries (together referred to as "the Group").

Operations in the reporting period

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share.

The Group's profit from its operations for the reporting period amounted to ISK 3,615 million. At the end of the reporting period, the Group employed 774 full-time members of staff, including 739 within the Bank itself.

Net interest income decreased by 4.5% between years, as the lower interest rate environment resulted in the net interest margin decreasing from 2.8% to 2.4%. Net fee and commission income increased by 14.9%, well distributed accross business segments. Salaries and related expenses were up by 10.1% between years as a result of wage increases in line with the general wage agreements in Iceland, redundancy costs and accrued leave, while other operating expenses decreased by 6.8%. The Bank's cost to income ratio decreased from 62.9% to 52% between years. Net impairments amounted to ISK 518 million and decreased from 3,490 million in the first quarter of 2020, when expected credit losses increased substantially due to the COVID-19 pandemic.

The Group's loan book grew by 2.3% in the period as the demand for new mortgages and refinancing continues at a strong pace. The Bank's ratio of non-performing loans fell from 2.9% to 2.4% as one material exposure was fully repaid. Stage 2 loans under IFRS 9 are however still at 15.6% as the credit risk related to loans to the tourism industry was deemed in 2020 to have materially increased due to the COVID-19 pandemic. While considerable uncertainty remains for that industry, it is well placed to recover strongly as international travel resumes after the pandemic.

Customer deposits increased by 2.8% from year-end 2020 due to strong growth in retail deposits. The Bank continued its consistent issuance of ISK denominated covered bonds to fund the growth in the mortgage book and also issued several private placements in Norwegian and Swedish kronas to refinance maturing debt. The liquidity position of the Bank remains robust, with limited maturities of long-term debt in 2021. The Bank is also very well capitalised, with a total capital ratio of 21.9% at the end of the period, compared to the current 17% regulatory requirement, which was lowered as the counter-cyclical buffer was reduced from 2.0% to zero in 2020.

The COVID-19 pandemic continued to impact the operations of the Bank for the first quarter. Most of the employees in the headquarters are still working from home and customer access to branches has been somewhat restricted. Despite these unusual circumstances, the Bank has managed to be fully operational and the main focus continues to be to help and support our customers through these difficulties.

The Annual General Meeting ("AGM") for the operating year 2020 was held on 18 March 2021. At the AGM shareholders approved that the Bank would pay ISK 3.4 billion in dividend, which amounts to about 50% of the 2020 net income and is in line with the Bank's dividend policy. It was also approved that the Board may convene a special shareholder meeting later in the year where a proposal regarding payment of dividends of profit for previous fiscal years could be suggested.

On 29 January 2021, the Minister of Finance and Economic Affairs made a formal decision to initiate the process of the sale of shares in Íslandsbanki in accordance with the ISFI (Icelandic State Financial Investments) proposal dated 17 December 2020.The ISFI is tasked with preparing Íslandsbanki for a listing on a local regulated stock market and the consequent sale of shares in a public offering (IPO) with the aim of a distributed ownership and the minimum of 25% of shares and a maximum of 35% of shares to be sold. Íslandsbanki has engaged ABN AMRO to act as an independent financial advisor to the Bank and ISFI has engaged their own advisors, joint global co-ordinators and bookrunners. Preparations for the IPO are well under way and the Minister of Finance and Economic Affairs has publicly stated that a listing is expected to take place in the summer of 2021, subject to market conditions.

The Bank has continued on its path to promote sustainability and in April 2021 the Bank joined 42 other leading banks to launch the net-zero banking alliance. The Bank has committed to becoming net-zero before 2040, in line with commitments by the Icelandic Government and 10 years earlier than commitments under the Paris agreement. In April, the Bank was also given the highest rating (90 out of 100 points) for sustainability that has been awarded by local ratings agency Reitun. Furthermore, the Bank has been awarded the Kuðungur (the Conch), the Ministry for the Environment and Natural Resources' environmental prize, for its outstanding work on environmental affairs in the past year.

Outlook

Given the size of the tourist sector as a source of almost 1/3 of export revenues and employer of around 14% of the labour force in 2019, the broad economic impact of the COVID-19 pandemic has been somewhat milder in Iceland than many feared. GDP contraction measured 6.6% in 2020, with the lions' share of the GDP decline due to a sharp fall in exports while domestic demand held up better than expected and a fall in imports offset the export decline to a degree. A combination of an effective economic policy and broadly successful health measures has mitigated the pandemic impact. Monetary conditions have been substantially eased and the government has introduced a raft of measures to support viable businesses and soften the impact from job loss or temporary closures on affected households. Furthermore, the general good health of balance sheets in both the private and public sectors has increased the scope for counter-cyclical economic policy and supported the resilience of households and corporates, even in the event of a temporary setback.

The pace of economic recovery in 2021 will hinge on how rapidly travel conditions normalise and economic activity resumes on a global scale. The increasing pace of the rollout of vaccines so far has gradually increased the upside potential for economic rebound in Iceland. Assuming fading impact from COVID-19 over the coming months, there is a good probability of a return to healthy GDP growth in the latter half of 2021. The Bank's Chief economist expects GDP growth to average 3.2% in 2021, driven by increasing exports as well as a boost to public investment and moderate consumption growth. For 2022, the expected 5.0% GDP growth will be largely driven by increasing domestic demand and further normalisation of the export sector.

With expectations of a strong economic recovery in 2021 and re-opening of Iceland for international tourism, the Bank is well placed to benefit along with its clients. The Bank's capital and liquidity position remains strong and the underlying earnings can be expected to benefit from a movement towards normalised impairments. The Bank has updated its financial targets and the aim is now to achieve a return on equity of 8-10% and a cost-to-income ratio below 45% by 2023.

Statement by the Board of Directors and the CEO

The interim financial statements for the period 1 January to 31 March 2021 have been prepared on a going concern basis in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable.

To the best of our knowledge, these interim financial statements provide a true and fair view of the Group's operating profits and cash flows in the reporting period and its financial position as of 31 March 2021. Furthermore, in our opinion the financial statements and the Director's report give fair view of the main operational developments and achievements and describe the principal risks and uncertainties that the Group faces in its operations.

The Board of Directors and the CEO have today discussed and approved the Condensed Consolidated Interim Financial Statements for the period 1 January to 31 March 2021.

Kópavogur, 5 May 2021

Board of Directors:

Hallgrímur Snorrason, Chairman

Heiðrún Jónsdóttir, Vice-Chairman

Anna Þórðardóttir

Árni Stefánsson

Frosti Ólafsson

Guðrún Þorgeirsdóttir

Jökull H. Úlfsson

Chief Executive Officer:

Birna Einarsdóttir

Report on Review of Condensed Consolidated Interim Financial Statements

To the Board of Directors and Shareholders of Íslandsbanki hf.

We have reviewed the accompanying Condensed Consolidated Interim Financial Statements of Íslandsbanki hf. and its subsidiaries as at March 31, 2021 which comprise of the Consolidated Interim Statement of Financial Position as at March 31, 2021 and the related Consolidated Interim Income Statement, the Consolidated Interim Statement of Comprehensive Income, the Consolidated Interim Statement of Changes in Equity and Consolidated Interim Statement of Cash Flows for the three months ended 31 March 2021 and explanatory notes. The Board of Directors and CEO are responsible for the preparation and fair presentation of these Condensed Consolidated Interim Financial Statements in accordance with the International Financial Reporting Standard, IAS 34 Interim Financial Reporting as adopted by the EU. Our responsibility is to express a conclusion on these Condensed Consolidated Interim Financial Statements based on our review.

Scope of Review

We conducted our review in accordance with the International Standard on Review Engagements 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity. A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements are not prepared, in all material respects, in accordance with the International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the EU.

Reykjavík, 5 May 2021

Margrét Pétursdóttir

State Authorised Public Accountant

Ernst & Young ehf.

Borgartúni 30

105 Reykjavík

Consolidated Interim Income Statement

	Notes	2021 1.1-31.3	2020 1.1-31.3
Interest income*		12,784	13,645
Interest expense		(4,594)	(5,065)
Net interest income	5	8,190	8,580
Fee and commission income		3,307	2,763
Fee and commission expense		(445)	(272)
Net fee and commission income	6	2,862	2,491
Net financial income (expense)	7	293	(1,738)
Net foreign exchange gain	8	130	55
Other operating income	9	123	19
Other net operating income		546	(1,664)
Total operating income		11,598	9,407
Salaries and related expenses	10	(3,574)	(3,247)
Other operating expenses	11	(2,278)	(2,445)
Contribution to the Depositors' and Investors' Guarantee Fund		(183)	(228)
Bank tax		(410)	(359)
Total operating expenses		(6,445)	(6,279)
Profit before net impairment on financial assets		5,153	3,128
Net impairment on financial assets	12	(518)	(3,490)
Profit (loss) before tax		4,635	(362)
Income tax expense	13	(1,036)	(769)
Profit (loss) for the period from continuing operations		3,599	(1,131)
Discontinued operations, net of income tax	14	16	(245)
Profit (loss) for the period		3,615	(1,376)
Profit (loss) attributable to shareholders of Íslandsbanki hf.		3,617	(1,251)
Loss attributable to non-controlling interests		(2)	(125)
Profit (loss) for the period		3,615	(1,376)
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	15	0.36	(0.10)

*Of which interest income amounting to ISK 12,346 million (2020: ISK 13,092 million) is calculated using the effective interest method.

The first quarter 2020 results were not reviewed or audited by the Bank's auditor.

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK million

Consolidated Interim Statement of Comprehensive Income

	2021 1.1-31.3	2020 1.1-31.3
Profit (loss) for the period	3,615	(1,376)
Net loss on financial assets	(59)	(309)
Net gain (loss) on financial liabilities	(196)	1,165
Items that will not be reclassified to the income statement	(255)	856
Foreign currency translation	34	-
Items that may subsequently be reclassified to the income statement	34	-
Other comprehensive income (expense) for the period, net of tax	(221)	856
Comprehensive income (expense) for the period	3,394	(520)

The first quarter 2020 results were not reviewed or audited by the Bank's auditor.

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK million

Consolidated Interim Statement of Financial Position

	Notes	31.3.2021	31.12.2020
Assets			
Cash and balances with Central Bank	20	88,748	78,948
Loans to credit institutions	21	103,333	89,920
Bonds and debt instruments	16	103,627	128,216
Derivatives	22	2,536	6,647
Loans to customers	23	1,029,415	1,006,717
Shares and equity instruments	16	25,763	14,851
Investments in associates	25	841	775
Property and equipment	26	7,191	7,341
Intangible assets		3,357	3,478
Other assets	27	17,566	4,125
Non-current assets and disposal groups held for sale	28	2,858	3,173
Total Assets		1,385,235	1,344,191
Liabilities			
Deposits from Central Bank and credit institutions	29	31,565	39,758
Deposits from customers	30	698,575	679,455
Derivative instruments and short positions	22	9,533	6,936
Debt issued and other borrowed funds	32	398,225	387,274
Subordinated loans	33	25,259	27,194
Tax liabilities		5,947	5,450
Other liabilities	35	30,660	11,920
Total Liabilities		1,199,764	1,157,987
Equity			
Share capital		10,000	10,000
Share premium		55,000	55,000
Reserves		6,353	6,181
Retained earnings		113,335	113,529
Total Shareholders' Equity		184,688	184,710
Non-controlling interests		783	1,494
Total Equity		185,471	186,204
Total Liabilities and Equity		1,385,235	1,344,191

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK million

Consolidated Interim Statement of Changes in Equity

	Share capital	Share premium	Statutory reserve	Restricted reserves	Fair value reserve	Liability credit reserve	Foreign currency translation reserve	Retained earnings	Total shareholders' equity	Non-controlling interests	Total equity
Equity as at 1.1.2021	10,000	55,000	2,500	3,556	572	(238)	(209)	113,529	184,710	1,494	186,204
Profit (loss) for the period								3,617	3,617	(2)	3,615
Dividends paid								(3,400)	(3,400)		(3,400)
Net loss on financial assets					(38)				(38)	(21)	(59)
Net loss on financial liabilities						(196)			(196)		(196)
Foreign currency translation							18		18	16	34
Restricted due to capitalised development costs				(72)				72	-		-
Restricted due to fair value changes				461				(461)	-		-
Restricted due to associates				(1)				1	-		-
Changes in non-controlling interests								(23)	(23)	(704)	(727)
Equity as at 31.3.2021	10,000	55,000	2,500	3,944	534	(434)	(191)	113,335	184,688	783	185,471
Equity as at 1.1.2020	10,000	55,000	2,500	3,525	1,432	(392)	-	105,569	177,634	2,428	180,062
Loss for the period								(1,251)	(1,251)	(125)	(1,376)
Net gain (loss) on financial assets					(219)			36	(183)	(126)	(309)
Net gain on financial liabilities						1,165		-	1,165		1,165
Restricted due to capitalised development costs				(73)				73	-		-
Restricted due to fair value changes				99				(99)	-		-
Restricted due to subsidiaries and associates				(21)				21	-		-
Equity as at 31.3.2020	10,000	55,000	2,500	3,530	1,213	773	-	104,349	177,365	2,177	179,542

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31 March 2021 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank. The Bank has one class of ordinary shares which carry no right to fixed income. The Annual General Meeting ("AGM") for the operating year 2020 was held on 18 March 2021. At the AGM shareholders approved the Board's proposal to pay dividends to shareholders amounting to ISK 3,400 million which is equivalent to ISK 0.34 per share (2019: none). The dividends were paid on 30 March 2021. It was also approved that the Board may convene a special shareholder meeting later in the year where a proposal regarding payment of dividends of profit for previous fiscal years could be suggested.

The first quarter 2020 Statement of Changes in Equity was not reviewed or audited by the Bank's auditor.

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK million

Consolidated Interim Statement of Cash Flows

	2021	2020
	1.1-31.3	1.1-31.3
Profit (loss) for the period	3,615	(1,376)
Non-cash items included in profit (loss) for the period*	4,541	8,612
Changes in operating assets and liabilities*	(6,820)	(2,553)
Dividends received	29	12
Income tax and bank tax paid	(1,096)	(1,096)
Net cash provided by operating activities	269	3,599
Proceeds from sales of property and equipment	15	8
Purchase of property and equipment	(30)	(351)
Purchase of intangible assets	(19)	(28)
Net cash used in investing activities	(34)	(371)
Proceeds from borrowings	32,683	8,260
Repayment and repurchases of borrowings	(14,840)	(6,027)
Repayment of lease liabilities	(102)	(97)
Dividends paid	(2,652)	-
Subsidiary's capital decrease and share buyback paid to non-controlling interests	(704)	-
Net cash provided by financing activities	14,385	2,136
Net increase in cash and cash equivalents	14,620	5,364
Effects of foreign exchange rate changes	(54)	177
Cash and cash equivalents at the beginning of the year	115,668	152,481
Cash and cash equivalents at the end of the period	130,234	158,022

Reconciliation of cash and cash equivalents	Notes		
Cash on hand	20	3,695	4,367
Cash balances with Central Bank	20	85,053	118,695
Bank accounts	21	51,225	37,649
Mandatory reserve, special restricted and pledged balances with Central Bank	20	(9,739)	(8,828)
Cash and cash equivalents attributable to discontinued operations		-	6,139
Cash and cash equivalents at the end of the period		130,234	158,022

*For further breakdown see the following page.

The Group has prepared its consolidated interim statement of cash flows using the indirect method. The statement is based on the net profit after tax for the period and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the period.

Interest received from 1 January to 31 March 2021 amounted to ISK 12,578 million (2020: ISK 13,636 million) and interest paid in the same period 2021 amounted to ISK 4,198 million (2020: ISK 5,982 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 first quarter 2020 Statement of Cash Flows was not reviewed or audited by the Bank's auditor.

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Amounts are in ISK million

Consolidated Interim Statement of Cash Flows

	2021 1.1-31.3	2020 1.1-31.3
Depreciation, amortisation and write-offs	345	448
Share of loss (profit) and reversal of impairment of associates	(66)	19
Accrued interest and fair value changes on debt issued and subordinated loans	2,889	2,359
Net impairment on financial assets	556	3,272
Foreign exchange gain	(130)	(1)
Net gain from sales of property and equipment	(7)	(2)
Unrealised fair value loss (gain) recognised in profit or loss	(493)	1,320
Discontinued operations, net of income tax	(16)	29
Bank tax	410	359
Income tax	1,036	760
Other changes	17	49
Non-cash items included in profit (loss) for the period	4,541	8,612

Mandatory reserve, special restricted and pledged balances with Central Bank	(190)	6,451
Loans to credit institutions	(10,283)	(6,169)
Bonds and debt instruments	24,063	(13,828)
Loans to customers	(30,802)	(9,879)
Shares and equity instruments	(11,142)	2,594
Other assets	(12,615)	(4,656)
Non-current assets and liabilities held for sale	278	(17)
Deposits from Central Bank and credit institutions	(7,751)	1,763
Deposits from customers	21,379	16,860
Derivative instruments and short positions	2,890	3,874
Other liabilities	17,353	454
Changes in operating assets and liabilities	(6,820)	(2,553)

Non-cash transactions 1 January to 31 March 2021

The Bank paid dividends to shareholders amounting to ISK 3,400 million of which ISK 748 million were withheld for capital income tax due in May 2021.

Non-cash transactions 1 January to 31 March 2020

During the period the Bank repurchased own debt securities amounting to ISK 3,152 million with cash settlement after the period-end.

The first quarter 2020 Statement of Cash Flows was not reviewed or audited by the Bank's auditor.

The notes on pages 12 to 57 are an integral part of these Condensed Consolidated Interim Financial Statements.

Notes to the Condensed Consolidated Interim Financial Statements

1. Corporate information

Íslandsbanki hf., the parent company, was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The condensed consolidated interim financial statements for the first quarter of 2021 ("the interim financial statements") comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

At the end of the period the Bank was wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The interim financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 5 May 2021.

2. Basis of preparation

The interim financial statements have been prepared in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The interim financial statements do not include all the information required for annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Group for the year ended 31 December 2020, as well as the unaudited Pillar 3 Report for the year 2020. Both are available on the Bank's website: www.islandsbanki.is.

The accounting policies and the basis of measurement are unchanged in comparison with Notes 3 and 67 in the consolidated financial statements for the year 2020 except for the changes presented in Note 3.

The interim financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At 31 March 2021 the exchange rate of the ISK against the USD was 126.31 and for the EUR 148.10 (year-end 2020: USD 127.21 and EUR 156.10).

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, the interim financial statements have been prepared on a going concern basis.

Significant accounting estimates and judgements

The preparation of the interim 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. Actual results may differ from those estimates.

Estimates and underlying assumptions are under constant review. Changes in accounting estimates are recognised when they occur.

As described in Note 3 in the consolidated financial statements for the year 2020 key sources of estimation uncertainty include the allowance for credit losses, the determination of fair value of financial instruments, and intangible assets.

Impairment of financial assets, changes from year-end 2020

Note 67.4 in the consolidated financial statements for the year 2020 contains a description of the Group's accounting policies for the impairment of financial assets.

At the end of the first quarter of 2021, the following changes have been made.

The Group's Chief Economist provided three new macroeconomic forecasts on 27 January 2021 which take into account the effects of the COVID-19 pandemic. The base case is shown below while the more optimistic and pessimistic forecasts are available on the Bank’s website.

2. Cont'd

Change in economic indicators %	Estimate 2020	Forcast 2021	Forcast 2022	Forcast 2023	Forcast 2024
Economic growth	(8.7)	3.2	5.0	3.6	2.8
Housing prices in Iceland	6.4	6.5	4.7	4.4	3.5
Purchasing power	3.0	1.1	2.1	2.1	1.6
ISK exchange rate index	11.1	(1.6)	(3.3)	(3.2)	-
Policy rate, Central Bank of Iceland	1.5	0.8	1.5	2.6	3.3
Inflation	2.8	3.0	2.2	2.3	2.2
Capital formation	(10.5)	3.8	3.5	8.4	3.5
thereof capital formation in industry	(11.8)	5.6	9.3	5.8	3.0

The Group continues to make temporary changes to the impairment model due to the COVID-19 pandemic.The Group's impairment process allows for temporary changes to the impairment model to account for circumstances when it becomes evident that existing or expected risk factors have not been appropriately considered in the credit risk rating or modelling process. The COVID-19 pandemic has created such circumstances for the tourism industry and therefore an adjustment is warranted. To account for the material uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they have been further classified into four impact groups as described in Note 45. Where the increase was found to be significant (groups 2 - 4), the exposure was transferred to Stage 2. In addition, an overlay factor was applied to the expected credit loss, comparable to an increase in up to three risk classes, and a higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios. The common risk factor in tourism was found to apply to loans to customers with a net carrying amount of ISK 93,780 million and the cumulative effect of the stage transfer and credit loss overlay amounted to ISK 7,729 million.

The All Risk Committee determined that it was appropriate to adjust the weights of the scenarios due to the COVID-19 pandemic, generally the scenarios are weighted 25%-50%-25% (good, base, bad) but it was determined appropriate to set the weights at 10%-55%-35%, as this would best represent the probability-weighted average over all possible scenarios. When deciding on the appropriate weights for the three scenarios, management used sensitivity analysis that indicated that a shift of 5% weight from the baseline to the pessimistic scenario would increase the impairment allowance by ISK 550 million while a 5% shift from the baseline to the optimistic scenario would in decrease the allowance by ISK 250 million.

Substantial uncertainty remains with regards to the impact of the COVID-19 pandemic on the credit quality of the Group's credit exposures in future periods and therefore the assessment of expected credit losses.

3. Changes to accounting policies

The accounting policies in the interim financial statements are consistent with those applied in the consolidated financial statements for the year 2020, except for amendments related to the Phase 2 of the Interest Rate Benchmark Reform as described in Note 4 in the consolidated financial statements for the year 2020. The amendments did not have a significant impact on the interim financial statements.

4. Operating segments

Segment information is presented in accordance with the Group's management and internal reporting structure. The segments' operating result are reported to the Board of Directors and the Chief Executive Officer, who are responsible for allocating resources to the reportable segments and assessing their financial performance.

An operating segment is a distinguishable component of the Group, for which discrete financial information is available, that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segment is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market.

The Bank has three main business segments: Personal Banking, Business Banking and Corporate & Investment Banking. Operating segments pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium. Capital allocation to the business units is based on the pillar 1 regulatory capital requirement, the pillar 2-R capital requirement calculated according to the Bank's ICAAP and the combined buffer requirement as stipulated in the Act on Financial Undertakings. Income tax and bank tax with breakdown for each segment is according to the current tax rates.

The Group comprises the following operating segments:

Personal Banking

Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. Íslandsbanki's customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services and contact the contact centre.

Business Banking

Business Banking provides small and medium-sized enterprises (SMEs) with comprehensive financial services and Ergo, the Bank's asset financing service, is also part of the division. Business Banking serves customers in business centres and branches close to their business. Via online banking and app, customers have full overview of their business and day-to-day operations are easy to manage.

Corporate & Investment Banking

Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors, and affluent individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage, and private banking services. The division is sector-focused, building and maintaining relationships with key customer segments within Iceland. Outside of Iceland, Íslandsbanki has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury and Proprietary Trading

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for relations with investors, financial institutions, stock exchanges, and rating agencies. Equity that is not allocated to business units sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres

Cost centres comprise the CEO's office (Human Resources, Marketing & Communications, Strategy, and Legal), Finance excluding Treasury and Proprietary Trading, IT, Risk Management and Compliance. Group Internal Audit is included in cost centres, however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank's Board of Directors.

Subsidiaries, eliminations and adjustments

Subsidiaries include Íslandssjóðir hf., Allianz Ísland hf. and other less significant subsidiaries (see Note 25).

Assets and liabilities of subsidiaries, that are classified as non-current assets and disposal groups held for sale, are included in the column “Other subsidiaries".

All inter-company eliminations are included in the column “Eliminations & adjustments".

Following is an overview showing the Group's performance with a breakdown by operating segments.

4. Cont'd

1 January to 31 March 2021	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	2,859	2,531	2,111	730	(46)	8,185	5	8,190
Net fee and commission income	922	518	1,068	(39)	(24)	2,445	417	2,862
Other net operating income	16	14	131	257	46	464	82	546
Total operating income	3,797	3,063	3,310	948	(24)	11,094	504	11,598
Salaries and related expenses	(595)	(479)	(429)	(65)	(1,803)	(3,371)	(203)	(3,574)
Other operating expenses	(601)	(258)	(215)	(43)	(1,074)	(2,191)	(87)	(2,278)
Contribution to the Depositors' and Investors' Guarantee Fund	(145)	(34)	(4)	-	-	(183)	-	(183)
Bank tax	(164)	(86)	(128)	(28)	(4)	(410)	-	(410)
Net impairment on financial assets	105	(167)	(441)	(16)	-	(519)	1	(518)
Cost allocation	(1,212)	(812)	(812)	62	2,774	-	-	-
Profit (loss) before tax	1,185	1,227	1,281	858	(131)	4,420	215	4,635
Income tax expense	(351)	(341)	(366)	34	33	(991)	(45)	(1,036)
Profit (loss) for the period from continuing operations	834	886	915	892	(98)	3,429	170	3,599
Net segment revenue from external customers	5,818	3,518	4,565	(2,811)	4	11,094	504	11,598
Net segment revenue from other segments	(2,021)	(455)	(1,255)	3,759	(28)	-	-	-
Fee and commission income	1,267	527	1,078	18	-	2,890	417	3,307
Depreciation, amortisation and write-offs	(40)	(18)	(4)	-	(280)	(342)	(3)	(345)
At 31 March 2021								
Loans to customers	450,552	234,003	344,662	198	-	1,029,415	-	1,029,415
Other assets	3,103	2,092	8,685	330,551	10,810	355,241	579	355,820
Total segment assets	453,655	236,095	353,347	330,749	10,810	1,384,656	579	1,385,235
Deposits from customers	334,012	197,053	136,903	33,501	-	701,469	(2,894)	698,575
Other liabilities	1,101	1,340	11,878	480,131	5,813	500,263	926	501,189
Total segment liabilities	335,113	198,393	148,781	513,632	5,813	1,201,732	(1,968)	1,199,764
Allocated equity	35,429	37,526	61,636	47,406	927	182,924	2,547	185,471
Risk exposure amount	225,338	236,918	404,664	70,387	6,244	943,551	11,161	954,712

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

Amounts are in ISK million

4. Cont'd

1 January to 31 March 2020	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	2,753	2,656	2,224	987	(65)	8,555	25	8,580
Net fee and commission income	809	466	916	(42)	1	2,150	341	2,491
Other net operating income	16	4	133	(1,848)	69	(1,626)	(38)	(1,664)
Total operating income	3,578	3,126	3,273	(903)	5	9,079	328	9,407
Salaries and related expenses	(611)	(453)	(412)	(80)	(1,501)	(3,057)	(190)	(3,247)
Other operating expenses	(596)	(281)	(233)	(53)	(1,134)	(2,297)	(148)	(2,445)
Contribution to the Depositors' and Investors' Guarantee Fund	(129)	(75)	(23)	(1)	-	(228)	-	(228)
Bank tax	(121)	(87)	(130)	(17)	(4)	(359)	-	(359)
Net impairment on financial assets	(64)	(2,321)	(1,042)	(63)	-	(3,490)	-	(3,490)
Cost allocation	(1,195)	(741)	(805)	68	2,673	-	-	-
Profit (loss) before tax	862	(832)	628	(1,049)	39	(352)	(10)	(362)
Income tax expense	(256)	194	(197)	(471)	(12)	(742)	(27)	(769)
Profit (loss) for the period from continuing operations	606	(638)	431	(1,520)	27	(1,094)	(37)	(1,131)
Net segment revenue from external customers	4,128	3,574	4,725	(3,400)	52	9,079	328	9,407
Net segment revenue from other segments	(550)	(448)	(1,452)	2,497	(47)	-	-	-
Fee and commission income	1,233	473	915	16	1	2,638	125	2,763
Depreciation, amortisation and write-offs	(51)	(23)	(5)	-	(281)	(360)	(2)	(362)
At 31 March 2020								
Loans to customers	331,041	235,747	357,061	1	-	923,850	-	923,850
Other assets	3,146	3,427	2,651	294,526	10,814	314,564	17,277	331,841
Total segment assets	334,187	239,174	359,712	294,527	10,814	1,238,414	17,277	1,255,691
Deposits from customers	295,270	179,387	128,270	48,499	-	651,426	(3,631)	647,795
Other liabilities	579	2,108	3,699	402,620	6,064	415,070	13,284	428,354
Total segment liabilities	295,849	181,495	131,969	451,119	6,064	1,066,496	9,653	1,076,149
Allocated equity	30,780	39,945	60,599	39,471	1,123	171,918	7,624	179,542
Risk exposure amount	191,352	239,392	392,678	54,510	6,358	884,290	27,085	911,375

Amounts are in ISK million

4. Cont'd

Subsidiaries, eliminations & adjustments

1 January to 31 March 2021	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	-	3	3	(1)	5
Net fee and commission income	323	118	(7)	(17)	417
Other net operating income	107	12	4	(41)	82
Total operating income	430	133	-	(59)	504
Salaries and related expenses	(155)	(48)	-	-	(203)
Other operating expenses	(48)	(75)	-	36	(87)
Net impairment on financial assets	-	-	-	1	1
Profit (loss) before tax	227	10	-	(22)	215
Income tax expense	(46)	(2)	-	3	(45)
Profit (loss) for the period from cont. operations	181	8	-	(19)	170
Net segment revenue from external customers	495	113	-	(104)	504
Net segment revenue from other segments	(65)	20	-	45	-
Fee and commission income	442	118	-	(143)	417
Depreciation, amortisation and write-offs	-	(1)	-	(2)	(3)
At 31 March 2021					
Total assets	2,486	1,340	7,080	(10,327)	579
Total liabilities	326	506	37	(2,837)	(1,968)
Total equity	2,160	834	7,043	(7,490)	2,547

1 January to 31 March 2020	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	11	5	9	-	25
Net fee and commission income	273	255	(8)	(179)	341
Other net operating income	(21)	19	(1)	(35)	(38)
Total operating income	263	279	-	(214)	328
Salaries and related expenses	(144)	(46)	-	-	(190)
Other operating expenses	(56)	(128)	-	36	(148)
Profit (loss) before tax	63	105	-	(178)	(10)
Income tax expense	(15)	(12)	-	-	(27)
Profit (loss) for the period from cont. operations	48	93	-	(178)	(37)
Net segment revenue from external customers	331	224	-	(227)	328
Net segment revenue from other segments	(68)	55	-	13	-
Fee and commission income	390	255	-	(520)	125
Depreciation, amortisation and write-offs	-	-	-	(2)	(2)
At 31 March 2020					
Total assets	2,731	1,297	25,792	(12,543)	17,277
Total liabilities	259	405	13,363	(4,374)	9,653
Total equity	2,472	892	12,429	(8,169)	7,624

Amounts are in ISK million

5. Net interest income

	2021 1.1-31.3	2020 1.1-31.3
Cash and balances with Central Bank	105	1,002
Loans at amortised cost	12,241	12,090
Financial assets mandatorily at fair value through profit or loss	436	551
Other assets	2	2
Total interest income	12,784	13,645
Deposits from Central Bank and credit institutions	(93)	(221)
Deposits from customers	(1,195)	(2,463)
Debt issued and other borrowed funds at fair value through profit or loss	(185)	(142)
Debt issued and other borrowed funds at amortised cost	(2,651)	(2,047)
Subordinated loans	(163)	(166)
Other interest expense*	(307)	(26)
Total interest expense	(4,594)	(5,065)
Net interest income	8,190	8,580

*Thereof is lease liabilities' interest expense amounting to ISK 20 million (2020: ISK 22 million).

6. Net fee and commission income

	2021 1.1-31.3	2020 1.1-31.3
Asset management	655	565
Investment banking and brokerage	660	571
Payment processing	945	814
Loans and guarantees	538	383
Other fee and commission income	509	430
Total fee and commission income	3,307	2,763
Brokerage	(90)	(53)
Clearing and settlement	(349)	(219)
Other fee and commission expense	(6)	-
Total fee and commission expense	(445)	(272)
Net fee and commission income	2,862	2,491

Fee and commission income by segment is disclosed in Note 4.

7. Net financial income (expense)

	2021 1.1-31.3	2020 1.1-31.3
Net gain (loss) on financial assets and financial liabilities mandatorily at FVTPL	181	(1,728)
Net gain (loss) on financial liabilities designated as at FVTPL	111	(6)
Net gain (loss) on fair value hedges	1	(4)
Net financial income (expense)	293	(1,738)

Amounts are in ISK million

8. Net foreign exchange gain

	2021 1.1-31.3	2020 1.1-31.3
Cash and balances with Central Bank	(54)	177
Financial assets mandatorily at fair value through profit or loss	(4,891)	1,378
Loans at amortised cost	(9,437)	29,750
Other assets	(2)	19
Net foreign exchange gain (loss) for assets	(14,384)	31,324
Deposits	2,700	(13,705)
Debt issued and other borrowed funds designated as at FVTPL	4,853	(7,084)
Debt issued and other borrowed funds at amortised cost	5,032	(8,700)
Subordinated loans	1,929	(1,780)
Net foreign exchange gain (loss) for liabilities	14,514	(31,269)
Net foreign exchange gain	130	55

9. Other operating income

	2021 1.1-31.3	2020 1.1-31.3
Share of profit (loss) of associates, net of income tax	6	(19)
Reversal of impairment for an associate	60	-
Legal fees	18	22
Rental income	11	10
Other net operating income	28	6
Other operating income	123	19

10. Salaries and related expenses

	2021 1.1-31.3	2020 1.1-31.3
Salaries	2,761	2,504
Contributions to pension funds	421	362
Social security charges and financial activities tax*	350	357
Other salary-related expenses	42	24
Salaries and related expenses	3,574	3,247

*Financial activities tax calculated on salaries is 5.5% (2020: 5.5%).

11. Other operating expenses

	2021 1.1-31.3	2020 1.1-31.3
Professional services	400	412
Software and IT expenses	1,038	1,100
Real estate and office equipment	162	136
Depreciation, amortisation and write-offs	345	362
Other administrative expenses	333	435
Other operating expenses	2,278	2,445

Amounts are in ISK million

12. Net impairment on financial assets

	2021 1.1-31.3	2020 1.1-31.3
Expected credit losses, on-balance sheet items*	(455)	(3,339)
Expected credit losses, off-balance sheet items	(63)	(151)
Net impairment on financial assets	(518)	(3,490)

*The main changes in the expected credit loss allowance are: an increase related to the COVID-19 pandemic (ISK 960 million), a decrease due to a more favourable economic environment (ISK 363 million) and a decreased expected credit loss for a few customers (ISK 215 million). For further information see Note 2.

13. Income tax expense

Recognised income tax is based on applicable tax laws. The income tax rate for legal entities in 2021 is 20% (2020: 20%). Special financial activities tax is calculated as 6% of the Bank's taxable profit exceeding ISK 1 billion in accordance with the Act on Financial Activities Tax no. 165/2011. The effective income tax rate in the Group's income statement for the first quarter 2021 is 22.4% (2020: negative 212.4%).

	2021 1.1-31.3	2020 1.1-31.3
Current tax expense excluding discontinued operations	1,450	1,467
Special financial activities tax	363	370
Difference in prior year's calculated income tax	2	-
Changes in deferred tax assets and deferred tax liabilities	(779)	(1,068)
Income tax recognised in the income statement	1,036	769

	2021 1.1-31.3		2020 1.1-31.3	
Profit (loss) before tax	4,635		(362)	
20% income tax calculated on the profit (loss) for the period	927	20.0%	(72)	20.0%
Special financial activities tax	363	7.8%	370	(102.2%)
Expenses (income) not subject to tax	(326)	(7.0%)	371	(102.5%)
Non-deductible expenses	82	1.8%	72	(20.0%)
Other differences	(10)	(0.2%)	28	(7.7%)
Effective income tax expense	1,036	22.4%	769	(212.4%)

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

14. Discontinued operations, net of income tax

	2021 1.1-31.3	2020 1.1-31.3
Net profit (loss) from foreclosed assets	27	(47)
Net loss from disposal groups held for sale	(6)	(217)
Income tax expense	(5)	19
Discontinued operations, net of income tax	16	(245)

Amounts are in ISK million

15. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2021	2020	2021	2020
	1.1-31.3	1.1-31.3	1.1-31.3	1.1-31.3
Profit (loss) attributable to shareholders of the Bank	3,601	(1,006)	3,617	(1,251)
Weighted average number of outstanding shares	10,000	10,000	10,000	10,000
Basic earnings per share	0.36	(0.10)	0.36	(0.13)

The Group's basic and diluted earnings per share are equal as the Group has not issued any options, warrants, convertibles, or other financial instruments that dilute earnings per share (2020: none).

16. Classification of financial assets and financial liabilities

At 31 March 2021	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	88,748	88,748
Loans to credit institutions	-	-	-	103,333	103,333
Listed bonds and debt instruments	68,567	-	-	-	68,567
Listed bonds and debt instruments used for economic hedging	35,033	-	-	-	35,033
Unlisted bonds and debt instruments	27	-	-	-	27
Derivatives	1,780	756	-	-	2,536
Loans to customers	-	-	-	1,029,415	1,029,415
Listed shares and equity instruments	4,624	-	-	-	4,624
Listed shares and equity instruments used for economic hedging	17,906	-	-	-	17,906
Unlisted shares and equity instruments	3,233	-	-	-	3,233
Other financial assets	-	-	-	16,298	16,298
Total financial assets	131,170	756	-	1,237,794	1,369,720
Deposits from Central Bank and credit institutions	-	-	-	31,565	31,565
Deposits from customers	-	-	-	698,575	698,575
Derivative instruments and short positions	9,533	-	-	-	9,533
Debt issued and other borrowed funds	-	45,104	89,903	263,218	398,225
Subordinated loans	-	-	-	25,259	25,259
Other financial liabilities	-	-	-	28,076	28,076
Total financial liabilities	9,533	45,104	89,903	1,046,693	1,191,233

Amounts are in ISK million

16. Cont'd

At 31 December 2020	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	78,948	78,948
Loans to credit institutions	-	-	-	89,920	89,920
Listed bonds and debt instruments	90,603	-	-	-	90,603
Listed bonds and debt instruments used for economic hedging	37,468	-	-	-	37,468
Unlisted bonds and debt instruments	145	-	-	-	145
Derivatives	5,639	1,008	-	-	6,647
Loans to customers	-	-	-	1,006,717	1,006,717
Listed shares and equity instruments	2,933	-	-	-	2,933
Listed shares and equity instruments used for economic hedging	9,109	-	-	-	9,109
Unlisted shares and equity instruments	2,809	-	-	-	2,809
Other financial assets	-	-	-	3,692	3,692
Total financial assets	148,706	1,008	-	1,179,277	1,328,991
Deposits from Central Bank and credit institutions	-	-	-	39,758	39,758
Deposits from customers	-	-	-	679,455	679,455
Derivative instruments and short positions	6,936	-	-	-	6,936
Debt issued and other borrowed funds	-	48,032	94,438	244,804	387,274
Subordinated loans	-	-	-	27,194	27,194
Other financial liabilities	-	-	-	9,721	9,721
Total financial liabilities	6,936	48,032	94,438	1,000,932	1,150,338

17. Fair value information for financial instruments

Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell 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 Group 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.

The table below shows financial instruments carried at fair value at 31 March 2021 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Valuation techniques based on observable inputs other than the quoted prices included in Level 1, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Valuation techniques based on significant unobservable inputs, e.g. internal assumptions.

At 31 March 2021	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	103,600	-	27	103,627
Derivatives	-	2,536	-	2,536
Shares and equity instruments	22,475	2	3,286	25,763
Non-current assets and disposal groups held for sale	-	-	1,201	1,201
Total financial assets	126,075	2,538	4,514	133,127
Short positions	323	-	-	323
Derivative instruments	-	9,210	-	9,210
Debt issued and other borrowed funds designated as at FVTPL	89,903	-	-	89,903
Total financial liabilities	90,226	9,210	-	99,436

Amounts are in ISK million

17. Cont'd

At 31 December 2020	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	128,071	-	145	128,216
Derivatives	-	6,647	-	6,647
Shares and equity instruments	11,931	30	2,890	14,851
Non-current assets and disposal groups held for sale	-	-	1,266	1,266
Total financial assets	140,002	6,677	4,301	150,980
Short positions	737	-	-	737
Derivative instruments	-	6,199	-	6,199
Debt issued and other borrowed funds designated as at FVTPL	94,438	-	-	94,438
Total financial liabilities	95,175	6,199	-	101,374

Changes in Level 3 assets measured at fair value	Bonds and debt instruments	Shares and equity instruments	Non-current assets
Fair value at 1 January 2021	145	2,890	1,266
Purchases	-	116	-
Sales	(116)	-	-
Net gain (loss) on financial instruments recognised in profit or loss	(2)	280	-
Net loss on financial instruments recognised in other comprehensive income	-	-	(65)
Fair value at 31 March 2021	27	3,286	1,201

	Bonds and debt instruments	Shares and equity instruments	Non-current assets
Fair value at 1 January 2020	1,348	6,016	-
Purchases	18	7	-
Sales	-	-	(2,028)
Net loss on financial instruments recognised in profit or loss	(1,256)	(2)	-
Net gain on financial instruments recognised in other comprehensive income	-	-	114
Transfer to "Non-current assets and disposal groups held for sale"	-	(3,180)	3,180
Other changes	35	49	-
Fair value at 31 December 2020	145	2,890	1,266

At the end of each reporting period the Group determines whether transfers have occurred between levels in the hierarchy, by reassessing categorisation based on the lowest level input that is significant to the fair value measurement as a whole. No transfers between levels took place during the period.

Valuation process

The responsibility for the valuation of the fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Valuation techniques

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

Amounts are in ISK million

17. Cont'd

Level 1: Fair value established from quoted market prices.

Assets at this level are financial assets and financial liabilities containing actively traded bonds and equities that are listed either domestically or abroad.

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

Assets at this level are assets and liabilities containing domestic bonds, equities as well as derivatives. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates.

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

Assets at this level contain primarily unlisted and illiquid equities and bonds. Unlisted equities and bonds are initially recorded at their transaction price but are revalued each quarter based on the models as described above.

At 31 March 2021 the Group's Level 3 shares amounted to ISK 3,286 million:

-These include shares in seven professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,681 million. The Group receives information from fund managers which use valuation models for the valuation of these equities.

-Other Level 3 shares amount to ISK 1,605 million.

At 31 March 2021 the Group's Level 3 bonds amounted to ISK 27 million:

-The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on projected risk and financing cost.

At 31 March 2021 the Group's Level 3 shares classified as an asset held for sale amounted to ISK 1,201 million:

The Group holds Series C preferred shares in Visa Inc. and at 31 March 2021 the valuation of the shares amounted to ISK 1,201 million, the shares were sold at the beginning of April 2021 for the valuation amount.

Sensitivity analysis for Level 3 assets

The valuations of Level 3 assets are in general uncertain and subject to various factors. The favourable and unfavourable scenarios can be considered as being likely movements in valuation within a year. The very favourable and very unfavourable scenarios are considered less likely, but not impossible and are not worst-case scenarios for some of the assets.

The table below shows how profit (loss) and total comprehensive income would have been affected if one or more of the inputs for fair value measurement in Level 3 were changed.

At 31 March 2021 **Effect on profit or (loss):**	Carrying amount	Very favourable	Favourable	Unfavourable	Very unfavour-able
Level 3 Bonds and debt instruments	27	290	68	(13)	(27)
Level 3 Shares and equity instruments	3,286	3,020	1,384	(867)	(1,184)

At 31 December 2020 **Effect on profit or (loss):**	Carrying amount	Very favourable	Favourable	Unfavourable	Very unfavour-able
Level 3 Bonds and debt instruments	145	1,015	773	(132)	(145)
Level 3 Shares and equity instruments	2,890	1,897	539	(571)	(878)
Effect on comprehensive income:					
Level 3 Non-current assets and disposal groups held for sale	1,266	1,898	949	(633)	(1,266)

Amounts are in ISK million

18. Financial instruments not carried at fair value

Assets

The fair value of “Loans to customers” may differ from their net carrying amount because the interest rates they carry may not reflect the interest rates that similar new loans would carry. The fair value is estimated by subtracting from or adding to the net carrying amount of the loans the discounted interest rate difference calculated from the reporting date until the next interest reset or maturity, whichever comes first. Since the interest rate difference is estimated using internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is adequately approximated by the carrying amount as they are short-term in nature. They are thus classified as Level 2.

Liabilities

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. Most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. The fair value for longer term fixed rate deposits is calculated with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

Observed market value is used for the fair value of "Debt issued and other borrowed funds" where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin in the Group's issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions and payments due to leasing contracts and they are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

The following table shows the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined in Note 17.

At 31 March 2021	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	88,748	-	88,748	88,748
Loans to credit institutions	-	103,333	-	103,333	103,333
Loans to customers	-	-	1,034,331	1,034,331	1,029,415
Other financial assets	-	16,298	-	16,298	16,298
Total financial assets	-	208,379	1,034,331	1,242,710	1,237,794
Deposits from Central Bank and credit institutions	-	31,627	-	31,627	31,565
Deposits from customers	-	698,701	-	698,701	698,575
Debt issued and other borrowed funds	204,533	118,142	-	322,675	308,322
Subordinated loans	-	25,154	-	25,154	25,259
Other financial liabilities	-	28,076	-	28,076	28,076
Total financial liabilities	204,533	901,700	-	1,106,233	1,091,797

At 31 December 2020	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	78,948	-	78,948	78,948
Loans to credit institutions	-	89,920	-	89,920	89,920
Loans to customers	-	-	1,010,315	1,010,315	1,006,717
Other financial assets	-	3,692	-	3,692	3,692
Total financial assets	-	172,560	1,010,315	1,182,875	1,179,277
Deposits from Central Bank and credit institutions	-	39,827	-	39,827	39,758
Deposits from customers	-	679,607	-	679,607	679,455
Debt issued and other borrowed funds	194,849	112,165	-	307,014	292,836
Subordinated loans	-	26,003	-	26,003	27,194
Other financial liabilities	-	9,721	-	9,721	9,721
Total financial liabilities	194,849	867,323	-	1,062,172	1,048,964

Amounts are in ISK million

Notes to the Condensed Consolidated Interim Financial Statements

19. Offsetting financial assets and financial liabilities

The following tables show reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 March 2021	Financial assets before netting	Netting with financial liabilities	Net financial assets	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 financial assets recognised in the balance sheet
Reverse repurchase agreements ..	161	-	161	-	-	-	161	-	161
Derivatives	2,536	-	2,536	(890)	(1,426)	(56)	164	-	2,536
Total assets	2,697	-	2,697	(890)	(1,426)	(56)	325	-	2,697
At 31 December 2020									
Reverse repurchase agreements ..	898	-	898	-	-	-	898	-	898
Derivatives	6,647	-	6,647	(761)	(4,330)	(187)	1,369	-	6,647
Total assets	7,545	-	7,545	(761)	(4,330)	(187)	2,267	-	7,545

	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 March 2021	Financial liabilities before netting	Netting with financial assets	Net financial liabilities	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 financial liabilities recognised in the balance sheet
Repurchase agreements	106	-	106	-	-	-	106	-	106
Derivative instruments and short positions	9,533	-	9,533	(890)	(1,886)	-	6,757	-	9,533
Total liabilities	9,639	-	9,639	(890)	(1,886)	-	6,863	-	9,639
At 31 December 2020									
Derivative instruments and short positions	6,936	-	6,936	(761)	(504)	-	5,671	-	6,936

20. Cash and balances with Central Bank

	31.3.2021	31.12.2020
Cash on hand	3,695	3,814
Balances with Central Bank	75,314	65,585
Balances with Central Bank subject to special restrictions*	1,281	1,288
Included in cash and cash equivalents	80,290	70,687
Cash and balances pledged as collateral to Central Bank	588	288
Mandatory reserve deposits with Central Bank	7,870	7,973
Cash and balances with Central Bank	88,748	78,948

*Balances as defined in Act no. 37/2016 on the treatment of króna-denominated assets subject to special restrictions and rules no. 490/2016 on special reserve requirements for new foreign currency inflows.

Amounts are in ISK million

21. Loans to credit institutions

	31.3.2021	31.12.2020
Money market loans	52,076	43,646
Bank accounts	51,225	46,269
Other loans	32	5
Loans to credit institutions	103,333	89,920

22. Derivative instruments and short positions

At 31 March 2021	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	1,164	120,795	3,324	109,670
Cross-currency interest rate swaps	118	4,340	1,222	42,491
Equity forwards	117	1,792	2,743	12,976
Foreign exchange forwards	339	11,730	908	17,850
Foreign exchange swaps	703	32,628	863	32,341
Foreign exchange options	-	-	2	25
Bond forwards	95	20,923	148	19,580
Derivatives	2,536	192,208	9,210	234,933
Short positions in listed bonds	-	-	323	227
Total	2,536	192,208	9,533	235,160

At 31 December 2020				
Interest rate swaps	1,888	181,914	3,581	62,275
Cross-currency interest rate swaps	2,861	63,067	45	3,171
Equity forwards	7	813	1,488	6,702
Foreign exchange forwards	70	4,010	362	8,582
Foreign exchange swaps	1,738	32,227	435	24,101
Foreign exchange options	-	-	1	25
Bond forwards	83	10,907	287	29,596
Derivatives	6,647	292,938	6,199	134,452
Short positions in listed bonds	-	-	737	550
Total	6,647	292,938	6,936	135,002

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

Short positions are in Icelandic Government bonds and bonds issued by municipalities, banks and public companies. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and other issuers. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain EUR denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate EUR denominated bonds (see Note 32) arising from changes in EURIBOR benchmark interest rates. The Group applies fair value hedge accounting to the hedging relationships and for the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of IBOR reform. At 31 March 2021 the total fair value of the interest rate swaps was positive and amounted to ISK 756 million (2020: ISK 1,008 million) and their total notional amount was ISK 44,430 million (2020: ISK 46,830).

Amounts are in ISK million

Notes to the Condensed Consolidated Interim Financial Statements

23. Loans to customers

At 31 March 2021	Gross carrying amount			Expected credit losses			Net carrying
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3	amount
Individuals	454,004	10,230	6,673	(1,526)	(257)	(868)	468,256
Commerce and services	61,129	59,312	5,518	(588)	(3,077)	(2,378)	119,916
Construction	35,980	4,979	804	(282)	(149)	(146)	41,186
Energy	7,879	687	-	(18)	(5)	-	8,543
Financial services	1,419	-	-	(1)	-	-	1,418
Industrial and transportation	45,367	29,865	4,064	(236)	(805)	(1,993)	76,262
Investment companies	16,905	5,537	918	(295)	(433)	(295)	22,337
Public sector and non-profit organisations	10,321	98	109	(15)	(1)	(15)	10,497
Real estate	113,196	41,917	6,484	(530)	(2,028)	(1,588)	157,451
Seafood	122,794	942	139	(204)	(8)	(114)	123,549
Loans to customers	868,994	153,567	24,709	(3,695)	(6,763)	(7,397)	1,029,415

At 31 December 2020							
Individuals	423,570	9,011	7,561	(1,608)	(254)	(903)	437,377
Commerce and services	60,062	64,350	5,958	(511)	(3,151)	(2,448)	124,260
Construction	36,551	5,420	997	(283)	(195)	(138)	42,352
Energy	7,997	701	-	(17)	(8)	-	8,673
Financial services	1,539	-	-	-	-	-	1,539
Industrial and transportation	46,526	30,971	3,989	(243)	(783)	(1,899)	78,561
Investment companies	15,287	5,504	3,628	(268)	(427)	(284)	23,440
Public sector and non-profit organisations	10,869	58	1	(17)	-	-	10,911
Real estate	112,189	42,169	6,794	(461)	(1,655)	(1,534)	157,502
Seafood	120,845	1,365	319	(237)	(9)	(181)	122,102
Loans to customers	835,435	159,549	29,247	(3,645)	(6,482)	(7,387)	1,006,717

24. Expected credit losses

Total allowances for expected credit losses

	Stage 1	Stage 2	Stage 3	Total
Cash and balances with Central Bank	2	-	-	2
Loans to credit institutions	132	-	-	132
Loans to customers	3,695	6,763	7,397	17,855
Other financial assets	15	4	-	19
Off-balance sheet loan commitments and financial guarantees	363	553	202	1,118
At 31 March 2021	4,207	7,320	7,599	19,126
Cash and balances with Central Bank	2	-	-	2
Loans to credit institutions	109	-	-	109
Loans to customers	3,645	6,482	7,387	17,514
Other financial assets	15	4	-	19
Off-balance sheet loan commitments and financial guarantees	347	483	225	1,055
At 31 December 2020	4,118	6,969	7,612	18,699

Amounts are in ISK million

24. Cont'd

The following tables reconcile the opening and closing balances for accumulated expected credit losses for loans to customers, and off-balance sheet loan commitments and financial guarantees.

Loans to customers

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2021	3,645	6,482	7,387	17,514
Transfer to Stage 1	235	(172)	(63)	-
Transfer to Stage 2	(106)	244	(138)	-
Transfer to Stage 3	(11)	(332)	343	-
Net remeasurement of loss allowance	(743)	221	(60)	(582)
New financial assets originated or purchased	761	393	102	1,256
Derecognitions and maturities	(86)	(73)	(106)	(265)
Write-offs	-	-	(187)	(187)
Recoveries of amounts previously written off	-	-	38	38
Foreign exchange	-	-	(17)	(17)
Unwinding of interest	-	-	98	98
At 31 March 2021	3,695	6,763	7,397	17,855

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2020	3,645	953	5,700	10,298
Transfer to Stage 1	3,577	(2,827)	(750)	-
Transfer to Stage 2	(1,743)	3,200	(1,457)	-
Transfer to Stage 3	(171)	(1,314)	1,485	-
Transfer to "Non-current assets and disposal groups held for sale"	(50)	(12)	(83)	(145)
Net remeasurement of loss allowance	(3,316)	6,024	1,201	3,909
New financial assets originated or purchased	2,104	597	2,516	5,217
Derecognitions and maturities	(401)	(139)	(404)	(944)
Write-offs	-	-	(1,498)	(1,498)
Recoveries of amounts previously written off	-	-	159	159
Foreign exchange	-	-	37	37
Unwinding of interest	-	-	481	481
At 31 December 2020	3,645	6,482	7,387	17,514

Off-balance sheet loan commitments and financial guarantees

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2021	347	483	225	1,055
Transfer to Stage 1	26	(18)	(8)	-
Transfer to Stage 2	(4)	19	(15)	-
Transfer to Stage 3	(1)	(8)	9	-
Net remeasurement of loss allowance	(212)	68	(62)	(206)
New loan commitments and financial guarantees	288	57	79	424
Derecognitions and maturities	(81)	(48)	(26)	(155)
At 31 March 2021	363	553	202	1,118
At 1 January 2020	403	55	231	689
Transfer to Stage 1	230	(146)	(84)	-
Transfer to Stage 2	(74)	252	(178)	-
Transfer to Stage 3	(11)	(53)	64	-
Net remeasurement of loss allowance	(466)	269	103	(94)
New loan commitments and financial guarantees	376	166	128	670
Derecognitions and maturities	(111)	(60)	(39)	(210)
At 31 December 2020	347	483	225	1,055

Amounts are in ISK million

Notes to the Condensed Consolidated Interim Financial Statements

25. Investments in subsidiaries and associates

Investments in subsidiaries		31.3.2021	31.12.2020
Íslandssjóðir hf., a fund management company, Hagasmári 3, 201 Kópavogur	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%

In addition Íslandsbanki has control over ten other non-significant subsidiaries.

Investments in associates		31.3.2021	31.12.2020
Auðkenni hf., an information security company, Borgartún 31, 105 Reykjavík	Iceland	23.8%	23.8%
JCC ehf., a cash centre service company, Sundaborg 15, 108 Reykjavík	Iceland	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company, Katrínartún 2, 105 Reykjavík	Iceland	30.1%	30.1%

26. Property and equipment

At 31 March 2021	Land and buildings	Right-of-use assets: Buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	3,058	4,729	3,119	10,906
Additions during the period	4	-	26	30
Disposals and write-offs during the period	-	-	(116)	(116)
Remeasurement	-	32	-	32
Historical cost	3,062	4,761	3,029	10,852
Balance at the beginning of the year	(1,340)	(906)	(1,319)	(3,565)
Depreciation during the period	(5)	(106)	(94)	(205)
Disposals and write-offs during the period	-	-	109	109
Accumulated depreciation	(1,345)	(1,012)	(1,304)	(3,661)
Carrying amount	1,717	3,749	1,725	7,191

At 31 December 2020	Land and buildings	Right-of-use assets: Buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	4,096	4,634	4,068	12,798
Additions during the year	35	-	441	476
Disposals and write-offs during the year	(120)	(69)	(583)	(772)
Remeasurement	-	184	-	184
Transfer to "Non-current assets and disposal groups held for sale"	(953)	(20)	(807)	(1,780)
Historical cost	3,058	4,729	3,119	10,906
Balance at the beginning of the year	(1,447)	(420)	(1,763)	(3,630)
Depreciation during the year	(19)	(421)	(398)	(838)
Disposals and write-offs during the year	17	(67)	455	405
Transfer to "Non-current assets and disposal groups held for sale"	109	2	387	498
Accumulated depreciation	(1,340)	(906)	(1,319)	(3,565)
Carrying amount	1,718	3,823	1,800	7,341

Amounts are in ISK million

27. Other assets

	31.3.2021	31.12.2020
Receivables	1,876	1,767
Unsettled securities transactions	13,851	1,550
Accruals	192	200
Prepaid expenses	389	181
Deferred tax assets	1,087	259
Other assets	171	168
Other assets	17,566	4,125

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

	31.3.2021	31.12.2020
Repossessed collateral:		
Land and buildings	1,303	1,548
Industrial equipment and vehicles	15	7
Assets of disposal groups classified as held for sale	1,540	1,618
Non-current assets and disposal groups held for sale	2,858	3,173

29. Deposits from Central Bank and credit institutions

	31.3.2021	31.12.2020
Deposits from credit institutions	31,520	39,650
Repurchase agreements with Central Bank	45	108
Deposits from Central Bank and credit institutions	31,565	39,758

30. Deposits from customers

	31.3.2021	31.12.2020
Demand deposits and deposits with maturity up to 3 months	608,775	582,746
Term deposits with maturity of more than 3 months	89,800	96,709
Deposits from customers	698,575	679,455

Deposits from customers specified by owners	31.3.2021		31.12.2020	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	9,739	1%	8,145	1%
Municipalities	11,088	2%	7,561	1%
Companies	332,439	48%	326,799	48%
Individuals	345,309	49%	336,950	50%
Deposits from customers	698,575	100%	679,455	100%

Amounts are in ISK million

31. Pledged assets

	31.3.2021	31.12.2020
Financial assets pledged as collateral against liabilities	279,780	236,901
Financial assets pledged as collateral with the Central Bank	5,451	5,088
Financial assets pledged as collateral in foreign banks	1,924	167
Pledged assets against liabilities	287,155	242,156

The Group has pledged assets against the issuance of covered bonds under Icelandic law, which are pledged on a pool of consumer mortgage loans. The Bank has issued additional covered bonds for its own use which accounts for a portion of the pledged assets. The carrying amount of these bonds at 31 March 2021 was ISK 33,477 million.

The Group has also pledged assets with the Central Bank to ensure the clearing of the Icelandic payment system as well as other contracts with the Central Bank, moreover, it has pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

32. Debt issued and other borrowed funds

	Issued	Maturity		Interest	31.3.2021	31.12.2020
Covered bonds in ISK	2019-2020	2021	At maturity	Fixed rates	4,992	5,076
Covered bonds in ISK	2015-2020	2023	At maturity	Fixed rates	30,095	29,496
Covered bonds in ISK	2020	2027	Amortising	Fixed rates	13,035	5,386
Covered bonds in ISK - CPI-linked	2015-2017	2022	At maturity	Fixed rates	19,250	19,228
Covered bonds in ISK - CPI-linked	2012-2018	2024	At maturity	Fixed rates	36,596	36,797
Covered bonds in ISK - CPI-linked	2015-2018	2026	At maturity	Fixed rates	28,986	28,571
Covered bonds in ISK - CPI-linked	2019-2020	2028	Amortising	Fixed rates	24,107	25,606
Covered bonds in ISK - CPI-linked	2017-2018	2030	At maturity	Fixed rates	26,588	26,285
Covered bonds					183,649	176,445
Senior unsecured bonds in SEK	2018	2021	At maturity	Fixed rates	-	1,553
Senior unsecured bonds in SEK	2018-2019	2021	At maturity	Floating rates	-	6,630
Senior unsecured bonds in SEK	2018	2021	At maturity	Floating rates	13,775	14,832
Senior unsecured bonds in EUR	2019	2021	At maturity	Floating rates	1,704	1,795
Senior unsecured bonds in SEK	2018	2022	At maturity	Floating rates	14,474	15,574
Senior unsecured bonds in EUR*	2019	2022	At maturity	Fixed rates	45,014	47,494
Senior unsecured bonds in NOK	2019	2022	At maturity	Floating rates	14,875	14,982
Senior unsecured bonds in EUR**	2018	2024	At maturity	Fixed rates	45,104	48,032
Senior unsecured bonds in NOK	2019	2024	At maturity	Fixed rates	5,966	6,187
Senior unsecured bonds in ISK	2019	2024	Monthly	Floating rates	2,493	2,664
Senior unsecured bonds in EUR*	2020	2023	At maturity	Fixed rates	44,889	46,944
Senior unsecured bonds in ISK	2020	2025	At maturity	Fixed rates	2,732	2,709
Senior unsecured bonds in NOK	2021	2024	At maturity	Floating rates	2,222	-
Senior unsecured bonds in SEK	2021	2024	At maturity	Floating rates	3,615	-
Senior unsecured bonds in NOK	2021	2025	At maturity	Floating rates	11,103	-
Senior unsecured bonds in SEK	2021	2025	At maturity	Floating rates	6,504	-
Bonds issued					214,470	209,396
Bills issued					-	1,433
Other debt securities					106	-
Debt issued and other borrowed funds					398,225	387,274

Amounts are in ISK million

32. Cont'd

*These bond issuances are classified as being designated as at fair value through profit or loss. At 31 March 2021 the total carrying amount of the bonds amounted to ISK 89,903 million and included in the amount are fair value changes amounting to ISK 754 million. The carrying amount of the bonds at 31 March 2021 was ISK 321 million higher than the contractual amount due at maturity.

**The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments (see Note 22). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in EURIBOR benchmark interest rates. The Group applies fair value hedge accounting to the hedging relationships and for the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of IBOR reform. At 31 March 2021 the total carrying amount of the bond issuance amounted to ISK 45,104 million and included in the amount are fair value changes amounting to ISK 679 million.

The Bank did not repurchase own bonds during the period.

The Bank has issued additional covered bonds for its own use, for example for the purpose of securities lending with regards to market making agreements. These covered bond amounts are not included in the total.

33. Subordinated loans

	Issued	Maturity		Interest	31.3.2021	31.12.2020
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	At maturity	Floating, STIBOR + 2.0%	10,838	11,646
Subordinated loans in SEK	2018	2028	At maturity	Floating, STIBOR + 2.5%	7,223	7,775
Subordinated loans in SEK	2019	2029	At maturity	Floating, STIBOR + 3.9%	7,198	7,773
Subordinated loans					25,259	27,194

34. Changes in liabilities arising from financing activities

			Non-cash changes			
	1.1.2021	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.3.2021
Covered bonds in ISK	39,958	7,680	484	-	-	48,122
Covered bonds in ISK - CPI-linked	136,487	(2,715)	1,755	-	-	135,527
Senior unsecured bonds in ISK	5,373	(182)	34	-	-	5,225
Senior unsecured bonds FX	61,553	15,094	226	(2,635)	-	74,238
Senior unsecured bonds FX at fair value	94,438	-	185	(4,853)	133	89,903
Senior unsecured bonds used for hedging	48,032	(531)	145	(2,397)	(145)	45,104
Other borrowed funds	1,433	(1,334)	7	-	-	106
Subordinated loans	27,194	(169)	163	(1,929)	-	25,259
Total	414,468	17,843	2,999	(11,814)	(12)	423,484

			Non-cash changes			
	1.1.2020	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.12.2020
Covered bonds in ISK	24,088	14,400	1,470	-	-	39,958
Covered bonds in ISK - CPI-linked	125,975	2,532	7,980	-	-	136,487
Senior unsecured bonds in ISK	3,553	1,728	92	-	-	5,373
Senior unsecured bonds FX	58,892	(7,093)	1,013	8,741	-	61,553
Senior unsecured bonds FX at fair value	49,352	38,069	608	6,468	(59)	94,438
Senior unsecured bonds used for hedging	41,816	(463)	566	6,061	52	48,032
Other borrowed funds	2,705	(1,330)	58	-	-	1,433
Subordinated loans	22,674	(738)	763	4,495	-	27,194
Total	329,055	47,105	12,550	25,765	(7)	414,468

Amounts are in ISK million

35. Other liabilities

	31.3.2021	31.12.2020
Accruals	2,638	2,311
Lease liabilities	3,892	3,962
Provision for effects of court rulings	288	288
Expected credit losses for off-balance sheet loan commitments and financial guarantees	1,118	1,055
Withholding tax	1,359	915
Unsettled securities transactions	19,137	1,379
Sundry liabilities	2,199	1,983
Non-current liabilities and disposal groups held for sale	29	27
Other liabilities	30,660	11,920

36. Custody assets

	31.3.2021	31.12.2020
Custody assets - not managed by the Group	2,972,371	2,863,328

37. Related party

Íslandsbanki is wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments (ISFI). As a result, the Icelandic Government and the Icelandic State Financial Investments are defined as related parties. The Group has applied the partial exemption for government-related entities, as described in IAS 24.

The Board of Directors and key management personnel of the Bank, ISFI and subsidiaries of the Bank, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner the Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third party counterparties.

Cash and balances with the Central Bank are disclosed under Note 20 and Deposits from the Central Bank are disclosed under Note 29.

All loans to employees are provided on general business terms of the Group and the balances do not reflect collaterals held by the Group.

At 31 March 2021	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Shareholders with control over the Group	-	-	-	3
Board of Directors, key management personnel and other related parties	540	398	142	49
Associated companies	26	144	(118)	228
Balances with related parties	566	542	24	280

1 January - 31 March 2021	Interest income	Interest expense	Other income	Other expense
Board of Directors, key management personnel and other related parties	4	-	-	-
Associated companies	-	-	-	386
Transactions with related parties	4	-	-	386

Amounts are in ISK million

37. Cont'd

At 31 December 2020	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Shareholders with control over the Group	-	-	-	3
Board of Directors, key management personnel and other related parties	440	393	47	45
Associated companies	31	342	(311)	228
Balances with related parties	471	735	(264)	276

1 January - 31 March 2020	Interest income	Interest expense	Other income	Other expense
Board of Directors, key management personnel and other related parties	2	-	-	-
Associated companies	-	1	-	414
Transactions with related parties	2	1	-	414

At 31 March 2021 total of ISK 9.2 million (at year-end 2020: none) were recognised as expected credit losses against balances outstanding, thereof ISK 2.4 million were recognised as Stage 1 expected credit losses and ISK 6.8 million were recognised as Stage 2 expected credit losses. No share option programmes were operated during the period.

38. Contingencies

Contingent liabilities

Borgun hf. – Landsbankinn hf. case

Borgun hf., a former subsidiary of Íslandsbanki, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun hf. in late 2014. Landsbankinn claims that Borgun's management did not disclose all available information that might have affected the value of Borgun hf. during the sales process, namely the value of its stake in Visa Europe which was sold to Visa International shortly after the Borgun hf. sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit against Borgun hf. and others on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. Landsbankinn does not quantify the claim, but its estimate of the lost profit from having sold its shares in Borgun hf. is approximately ISK 1,930 million. Court appointed assessors presented their assessment in November 2019. A reassessment was demanded and senior assessors, appointed by the court. The senior assessors have not rendered their assessment. It is uncertain when a ruling is to be expected. In 2020, the Group closed an agreement on the sale of all its stake in Borgun hf. In that agreement Íslandsbanki undertook to reimburse 63.47% of losses incurred by Borgun hf. or the buyer as a result of an unfavourable outcome in the Landsbanki case. The Group has not recognised a provision as a result of this event.

39. Events after the reporting period

Íslandssjóðir hf., a wholly owned subsidiary of Íslandsbanki, is a fund management company that manages assets on behalf of customers. One of the assets under the management of Íslandssjóðir hf. is the alternative investment fund 105 Miðborg slhf., a limited partnership that is constructing a real estate project that includes residential housing, hotel and office facilities. In December 2017 Íslenskir aðalverktakar hf. (ÍAV) and 105 Miðborg slhf. signed a contract where ÍAV undertook to be the steering contractor for the first phase of the project. On 19 February 2021, 105 Miðborg slhf. terminated the agreement claiming default by ÍAV. On 3 May 2021, ÍAV filed a suit against both Miðborg slhf. and Íslandssjóðir hf., demanding payment of approximately ISK 3.8 billion for services allegedly rendered. 105 Miðborg slhf. has previously rejected ÍAV's claims and is currently preparing a counter suit against ÍAV. Íslandssjóðir hf. believes, and has previously stated, that the company is not directly involved in the dispute. Given that the suit was filed two days ago the Group has not had an opportunity to scrutinise the claims made in the suit. The Group has not recognised a provision as a result of this event.

No other events have arisen after the reporting period that require amendments or additional disclosures in the interim financial statements for the first quarter 2021.

Amounts are in ISK million

40. Risk management

Risk governance

The Group is exposed to various risk factors and managing these risks is an integral part of its operations. More information about the Group's risk management and risk assessment processes is available in the unaudited Pillar 3 2020 Report, which is available on the Bank's website: www.islandsbanki.is.

41. Credit risk

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 financial contract with the Group.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. industrial sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes 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 loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as financial guarantees, loan commitments and derivatives.

The Group has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Group's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Group measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

42. Maximum credit exposure

The Group'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. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions that have been made because of these items. The maximum credit exposure for a derivative contract is calculated by adding potential future credit exposure to the positive market value of the contract.

The industry breakdown shows the 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 Government guarantee schemes issued in response to the COVID-19 pandemic are presented in the line item "Loans to customers". Of these, ISK 2,379 million are subject to 100% Government guarantee, ISK 1,065 million to 85% Government guarantee and ISK 542 million to 70% Government guarantee.

As a part of the agreement on the sale of Borgun hf. in 2020 the Group took on certain guarantees with regards to chargeback risk that Borgun hf. is exposed to through its operations, which at 31 March 2021 amounted to about ISK 134 million. These guarantees are not included in the table below.

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

At 31 March 2021	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	88,748	-	-	-	-	-	-	-	-	-	88,748
Loans to credit institutions	-	-	-	-	-	103,333	-	-	-	-	-	103,333
Bonds and debt instruments	-	82,771	664	-	456	18,890	-	9	136	701	-	103,627
Derivatives	-	80	131	7	13	4,880	185	780	-	176	306	6,558
Loans to customers:	468,256	-	119,916	41,186	8,543	1,418	76,262	22,337	10,497	157,451	123,549	1,029,415
Overdrafts	10,086	-	10,882	3,598	35	983	5,715	581	497	2,783	4,352	39,512
Credit cards	12,928	-	1,119	230	5	14	313	23	82	64	33	14,811
Mortgages	410,781	-	-	-	-	-	-	-	-	-	-	410,781
Capital leases	5,532	-	25,588	2,924	16	-	7,289	122	35	232	167	41,905
Government guarantee schemes	18	-	3,259	128	-	-	339	19	-	136	87	3,986
Other loans	28,911	-	79,068	34,306	8,487	421	62,606	21,592	9,883	154,236	118,910	518,420
Other financial assets	549	457	431	9	12	14,260	41	322	93	104	20	16,298
Off-balance sheet items:	34,912	-	49,227	13,637	307	7,525	26,428	1,260	5,079	15,728	16,847	170,950
Financial guarantees	474	-	5,713	6,847	5	447	2,304	17	5	1,889	577	18,278
Undrawn loan commitments	-	-	23,059	3,482	-	-	17,493	630	-	10,719	5,158	60,541
Undrawn overdrafts	9,589	-	15,711	2,481	271	6,833	5,488	409	3,774	2,809	10,915	58,280
Credit card commitments	24,849	-	4,744	827	31	245	1,143	204	1,300	311	197	33,851
Maximum credit exposure	503,717	172,056	170,369	54,839	9,331	150,306	102,916	24,708	15,805	174,160	140,722	1,518,929

Amounts are in ISK million

42. Cont'd

At 31 December 2020	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	78,948	-	-	-	-	-	-	-	-	-	78,948
Loans to credit institutions	-	-	-	-	-	89,920	-	-	-	-	-	89,920
Bonds and debt instruments	-	107,502	22	-	1,257	18,192	116	7	191	929	-	128,216
Derivatives	-	165	66	-	-	8,436	239	669	-	65	273	9,913
Loans to customers:	437,377	-	124,260	42,352	8,673	1,539	78,561	23,440	10,911	157,502	122,102	1,006,717
Overdrafts	10,506	-	12,117	3,104	10	1,097	5,915	954	949	2,422	5,138	42,212
Credit cards	14,942	-	1,170	247	6	14	318	23	77	62	29	16,888
Mortgages	377,155	-	-	-	-	-	-	-	-	-	-	377,155
Capital leases	5,612	-	26,236	2,742	16	-	7,328	153	38	1,058	176	43,359
Government guarantee schemes	15	-	2,968	57	-	-	323	9	-	136	86	3,594
Other loans	29,147	-	81,769	36,202	8,641	428	64,677	22,301	9,847	153,824	116,673	523,509
Other financial assets	437	645	110	10	6	2,285	29	39	88	35	8	3,692
Off-balance sheet items:	33,695	-	29,294	13,373	316	7,376	26,056	1,531	5,348	21,209	14,190	152,388
Financial guarantees	489	-	5,349	6,786	-	90	2,077	30	6	8,090	272	23,189
Undrawn loan commitments	-	-	5,445	3,111	-	-	17,896	846	-	10,145	2,583	40,026
Undrawn overdrafts	9,722	-	13,826	2,679	286	7,051	4,901	446	4,026	2,664	11,145	56,746
Credit card commitments	23,484	-	4,674	797	30	235	1,182	209	1,316	310	190	32,427
Maximum credit exposure	471,509	187,260	153,752	55,735	10,252	127,748	105,001	25,686	16,538	179,740	136,573	1,469,794

43. 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 Group takes a charge over assets such as real estate, vessels, cash and securities 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 Group 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. Exception from this are Government guarantees issued in response to the COVID-19 pandemic which are shown under other collateral. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

Amounts are in ISK million

43. Cont'd

Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Group'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 the gross carrying amount of loans and nominal off-balance sheet items, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their gross carrying amount, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. The maximum credit risk exposure is measured on net carrying value basis, and therefore collateral allocation can in some instances be higher. For capital leases the Group remains the owner of the leased object. In total ISK 37,135 million of the collateral are leased objects.

The following tables show the maximum exposure to credit risk by class of financial asset and collateral held against those exposures. An overview of collateral held by the Group against credit exposure is shown below for exposures in Stages 1 and 2 (non credit-impaired) and exposures in Stage 3 (credit-impaired):

At 31 March 2021 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Total credit exposure not covered by collateral	Associated ECL
Derivatives	6,558	-	-	3,059	-	-	3,059	3,499	-
Loans and commitments to customers:	1,182,642	742,792	100,687	6,292	48,613	99,026	997,410	185,232	11,374
Individuals	497,305	419,505	5	315	14,310	140	434,275	63,030	1,861
Commerce and services	165,809	60,538	158	914	24,640	27,536	113,786	52,023	4,093
Construction	54,135	37,756	3	1,432	2,236	2,317	43,744	10,391	542
Energy	8,850	6,519	-	8	13	12	6,552	2,298	23
Financial services	8,943	1,286	-	1	-	3,548	4,835	4,108	6
Industrial and transportation	100,586	38,279	7	499	7,047	29,932	75,764	24,822	1,169
Investment companies	22,973	8,117	-	1,956	78	11,754	21,905	1,068	739
Public sector and non-profit organisations	15,470	928	-	5	25	-	958	14,512	18
Real estate	168,205	154,135	-	571	191	2,769	157,666	10,539	2,698
Seafood	140,366	15,729	100,514	591	73	21,018	137,925	2,441	225
Total	1,189,200	742,792	100,687	9,351	48,613	99,026	1,000,469	188,731	11,374
Collateral held against credit-impaired exposures									
Loans and commitments to customers:	17,723	12,983	1,396	57	635	878	15,949	1,774	7,599
Individuals	5,863	5,184	17	4	135	4	5,344	519	902
Commerce and services	3,334	1,448	634	2	197	687	2,968	366	2,501
Construction	688	460	-	-	72	47	579	109	157
Industrial and transportation	2,104	435	733	5	216	129	1,518	586	2,005
Investment companies	624	608	-	-	6	-	614	10	295
Public sector and non-profit organisations	106	98	-	-	-	-	98	8	16
Real estate	4,974	4,731	6	46	7	11	4,801	173	1,608
Seafood	30	19	6	-	2	-	27	3	115
Total	17,723	12,983	1,396	57	635	878	15,949	1,774	7,599

Amounts are in ISK million

43. Cont'd

At 31 December 2020 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Total credit exposure not covered by collateral	Associated ECL
Derivatives	9,913	-	-	5,318	-	-	5,318	4,595	-
Loans and commitments to customers:	1,136,660	706,096	95,947	11,869	49,504	102,673	966,089	170,571	10,957
Individuals	464,333	382,505	7	376	14,327	151	397,366	66,967	1,939
Commerce and services	149,751	61,610	157	659	25,444	32,211	120,081	29,670	4,029
Construction	54,812	41,329	11	1,297	2,108	2,249	46,994	7,818	570
Energy	8,989	6,545	-	1	14	14	6,574	2,415	25
Financial services	8,915	1,083	-	26	-	3,543	4,652	4,263	2
Industrial and transportation	102,499	39,750	12	178	7,088	29,500	76,528	25,971	1,127
Investment companies	21,626	6,903	-	1,891	79	11,125	19,998	1,628	709
Public sector and non-profit organisations	16,258	1,007	-	5	28	-	1,040	15,218	20
Real estate	173,328	149,991	-	7,424	343	1,157	158,915	14,413	2,280
Seafood	136,149	15,373	95,760	12	73	22,723	133,941	2,208	256
Total	1,146,573	706,096	95,947	17,187	49,504	102,673	971,407	175,166	10,957
Collateral held against credit-impaired exposures									
Loans and commitments to customers:	22,445	14,644	1,556	2,704	725	917	20,546	1,899	7,612
Individuals	6,739	5,973	21	3	144	4	6,145	594	935
Commerce and services	3,803	1,706	691	3	232	780	3,412	391	2,573
Construction	913	630	-	-	87	50	767	146	151
Industrial and transportation	2,118	431	810	51	246	71	1,609	509	1,922
Investment companies	3,345	714	-	2,611	6	-	3,331	14	284
Public sector and non-profit organisations	1	1	-	-	-	-	1	-	-
Real estate	5,383	5,082	5	36	7	12	5,142	241	1,565
Seafood	143	107	29	-	3	-	139	4	182
Total	22,445	14,644	1,556	2,704	725	917	20,546	1,899	7,612

Amounts are in ISK million

44. Credit quality of financial assets

The following table provides the gross carrying amount of loans and credit risk exposure on loan commitments and financial guarantees. Amounts are broken down by risk class and the method by which their respective credit loss allowances (ECL) are calculated, i.e. Stage 1, 2 and 3.

The Group 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 Group uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Group 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.

Risk classes 1-4 represent low risk, risk classes 5-6 moderate risk, risk classes 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers that are in default. Unrated are loans that are yet to be rated.

Further information on the risk classes, including the mapping from risk classes to the probability of default, can be found in Section 4.2.2 of the unaudited Pillar 3 2020 Report.

The same customer can have loans and off-balance sheet commitments in Stages 1 and 2 simultaneously. However, if a customer has an exposure in Stage 3 then all other loans and commitments are classified as Stage 3 as well.

At 31 March 2021

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	237,390	1,241	-	238,631
Risk class 5-6	360,529	60,086	-	420,615
Risk class 7-8	231,340	78,815	-	310,155
Risk class 9	39,338	13,294	-	52,632
Risk class 10	-	-	24,709	24,709
Unrated	397	131	-	528
	868,994	153,567	24,709	1,047,270
Expected credit losses	(3,695)	(6,763)	(7,397)	(17,855)
Net carrying amount	865,299	146,804	17,312	1,029,415

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	89,373	1,247	-	90,620
Risk class 5-6	44,195	7,094	-	51,289
Risk class 7-8	12,226	15,874	-	28,100
Risk class 9	915	337	-	1,252
Risk class 10	-	-	613	613
Unrated	120	74	-	194
	146,829	24,626	613	172,068
Expected credit losses	(363)	(553)	(202)	(1,118)
Total	146,466	24,073	411	170,950

Amounts are in ISK million

44. Cont'd

At 31 March 2021	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	106,041	195,238	161,438	36,439	6,770	5	(2,763)	503,168
Commerce and services	39,589	64,512	59,481	5,898	5,808	449	(6,594)	169,143
Construction	5,680	19,774	26,676	2,490	802	100	(699)	54,823
Energy	4,799	3,309	765	-	-	-	(23)	8,850
Financial services	5,432	2,976	526	-	-	15	(6)	8,943
Industrial and transportation	15,361	56,433	27,180	2,716	4,174	-	(3,174)	102,690
Investment companies	803	4,816	16,242	1,803	922	45	(1,034)	23,597
Public sector and non-profit organisations	13,969	1,234	258	-	121	28	(34)	15,576
Real estate	43,010	79,525	44,182	4,127	6,581	60	(4,306)	173,179
Seafood	94,567	44,087	1,507	411	144	20	(340)	140,396
Total	329,251	471,904	338,255	53,884	25,322	722	(18,973)	1,200,365

At 31 December 2020

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	232,806	1,209	-	234,015
Risk class 5-6	346,781	62,788	-	409,569
Risk class 7-8	217,368	80,867	-	298,235
Risk class 9	38,290	14,684	-	52,974
Risk class 10	-	-	29,247	29,247
Unrated	190	1	-	191
	835,435	159,549	29,247	1,024,231
Expected credit losses	(3,645)	(6,482)	(7,387)	(17,514)
Net carrying amount	831,790	153,067	21,860	1,006,717

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	64,781	1,341	-	66,122
Risk class 5-6	51,169	6,461	-	57,630
Risk class 7-8	10,852	16,227	-	27,079
Risk class 9	1,142	553	-	1,695
Risk class 10	-	-	809	809
Unrated	99	8	-	107
	128,043	24,590	809	153,442
Expected credit losses	(347)	(483)	(225)	(1,055)
Total	127,696	24,107	584	152,387

Amounts are in ISK million

44. Cont'd

At 31 December 2020	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	94,574	182,706	153,088	35,928	7,646	4	(2,874)	471,072
Commerce and services	25,813	62,494	58,182	7,121	6,402	144	(6,602)	153,554
Construction	4,809	22,332	26,078	2,130	1,064	33	(721)	55,725
Energy	5,006	3,338	670	-	-	-	(25)	8,989
Financial services	5,816	2,650	443	-	-	8	(2)	8,915
Industrial and transportation	15,557	56,578	28,547	2,895	4,039	50	(3,049)	104,617
Investment companies	868	5,171	14,695	1,599	3,628	2	(993)	24,970
Public sector and non-profit organisations	14,525	1,400	324	1	1	28	(20)	16,259
Real estate	46,297	82,945	42,299	4,057	6,950	8	(3,845)	178,711
Seafood	86,872	47,585	988	938	326	21	(438)	136,292
Total	300,137	467,199	325,314	54,669	30,056	298	(18,569)	1,159,104

45. Loans to customers in the tourism industry likely to be vulnerable to COVID-19 pandemic

Companies susceptible to the impact of COVID-19 were classified into four groups based on an assessment of how much an increase in credit risk these companies face in the short, medium and long term. In addition, to account for the material uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they are further classified into four groups based on an assessment of how vulnerable they are to various assumptions on when tourists can be expected to start visiting Iceland again. The base case assumes around 700.000 tourists in Iceland in 2021.

Impact group 1: viable even though significantly fewer tourists arrive in the year 2021
Impact group 2: viable with forbearance even though significantly fewer tourists arrive in the year 2021
Impact group 3: viable if the number of tourists in the year 2021 is similar to the base case
Impact group 4: viable if the year 2021 turns out to be better than the base case

Where the increase was found to be significant (groups 2-4), the exposure was transferred to Stage 2. In addition, an overlay factor was applied to the expected credit loss, comparable to an increase in up to three risk classes, and a higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios.

At 31 March 2021

Loans to customers in the tourism industry:	Stage 1	Stage 2	Stage 3	Total
Group 1	2,334	16,007	-	18,341
Group 2	-	16,258	402	16,660
Group 3	-	57,843	3,158	61,001
Group 4	-	2,165	3,342	5,507
	2,334	92,273	6,902	101,509
Expected credit losses	(15)	(5,072)	(2,642)	(7,729)
Net carrying amount	2,319	87,201	4,260	93,780

Off-balance sheet loan commitments and financial guarantees to customers in the tourism industry:

	Stage 1	Stage 2	Stage 3	Total
Group 1	136	-	-	136
Group 2	-	13,445	38	13,483
Group 3	-	5,061	170	5,231
Group 4	-	323	21	344
	136	18,829	229	19,194
Expected credit losses	(3)	(510)	(102)	(615)
Total	133	18,319	127	18,579

Amounts are in ISK million

45. Cont'd

At 31 December 2020

Loans to customers in the tourism industry:	Stage 1	Stage 2	Stage 3	Total
Group 1	1,903	308	-	2,211
Group 2	-	30,503	406	30,909
Group 3	-	58,610	2,579	61,189
Group 4	-	3,317	3,612	6,929
	1,903	92,738	6,597	101,238
Expected credit losses	(24)	(4,483)	(2,529)	(7,036)
Net carrying amount	1,879	88,255	4,068	94,202

Off-balance sheet loan commitments and financial guarantees to customers in the tourism industry:

	Stage 1	Stage 2	Stage 3	Total
Group 1	50	2	-	52
Group 2	-	13,416	51	13,467
Group 3	-	5,118	163	5,281
Group 4	-	429	17	446
	50	18,965	231	19,246
Expected credit losses	(3)	(363)	(101)	(467)
Total	47	18,602	130	18,779

46. Forbearance

When restructuring or modification measures are believed to be more appropriate than collection procedures, the Group offers several debt relief measures and restructuring frameworks for customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants.

The relationship between forbearance and stages is discussed in Note 67.4 in the consolidated financial statements for the year 2020.

Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for a loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:

- All of the customer's facilities have to be considered performing; and
- The customer does not have any contract that is more than 30 days past due; and
- The probation period of two years has passed from the date of the forbearance event; and
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period

Because of the COVID-19 pandemic, the Group entered into an agreement with other financial institutions and lenders in Iceland to provide a moratorium for customers, uniformly executed across institutions. In the interim financial statements for the third quarter of 2020 the Group showed the extent of the payment moratoria granted by the Group under these initiatives. The agreement expired on 30 September 2020 and all moratoria under it has expired. Further extensions of moratoria has been granted on a case-by-case basis and is now classified as forbearance.

The tourism industry is an important economic sector in Iceland but due to the nature of tourism, its effects are not limited to hotels, car rentals and tour guides. The Group therefore monitors the tourism industry internally as a quasi-sector instead of a new separate sector. Real estate companies that do not operate directly in the tourism sector but rely in part on rental income from such activities explain around half of the forbearance amount for companies not in tourism.

The following table provides a summary of the Group's forborne assets. The loans that previously were in payment moratorium and are now forborne are shown separately.

Financial Statements first quarter 2021 45 Amounts are in ISK million

46. Cont'd

At 31 March 2021	Stage 1	Stage 2	Stage 3	Total
Individuals	1,255	6,803	1,970	10,028
Companies	1,232	102,706	11,323	115,261
- In the tourism quasi-sector	-	65,177	5,505	70,682
- Other than the tourism quasi-sector	1,232	37,529	5,818	44,579
Gross carrying amount	2,487	109,509	13,293	125,289

	Stage 1	Stage 2	Stage 3	Total
Individuals	(12)	(145)	(179)	(336)
Companies	(11)	(4,658)	(4,320)	(8,989)
- In the tourism quasi-sector	-	(3,447)	(1,992)	(5,439)
- Other than the tourism quasi-sector	(11)	(1,211)	(2,328)	(3,550)
Expected credit losses	(23)	(4,803)	(4,499)	(9,325)

At 31 December 2020	Stage 1	Stage 2	Stage 3	Total
Individuals	932	5,249	2,068	8,249
Companies	209	104,523	13,608	118,340
- In the tourism quasi-sector	-	62,295	5,747	68,042
- Other than the tourism quasi-sector	209	42,228	7,861	50,298
Gross carrying amount	1,141	109,772	15,676	126,589

	Stage 1	Stage 2	Stage 3	Total
Individuals	(10)	(127)	(176)	(313)
Companies	(1)	(4,114)	(4,147)	(8,262)
- In the tourism quasi-sector	-	(2,787)	(1,888)	(4,675)
- Other than the tourism quasi-sector	(1)	(1,327)	(2,259)	(3,587)
Expected credit losses	(11)	(4,241)	(4,323)	(8,575)

47. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the period by taking possession of collateral held as security against loans.

	31.3.2021	31.12.2020
Property and land	46	1,754
Industrial equipment and vehicles	40	86
Total	86	1,840

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations.

Amounts are in ISK million

48. Write-offs

When the Group has no reasonable expectations of recovering a credit exposure or when it is uneconomical to pursue legal collection, the financial asset is written off. A write-off does not change the debt obligation which is therefore still subject to enforcement activity. Any recoveries of amounts previously written off are credited to the income statement.

Gross carrying amount written off and still subject to enforcement activity	2021 1.1-31.3	2020 1.1-31.3
Individuals	49	128
Companies	153	72
Total	202	200

49. Large exposures disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group'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 regulation no. 233/2017. The Group has internal criteria that define connections between clients. These criteria reflect the Group's interpretation of Article (1)(a) of the Act on Financial Undertakings no. 161/2002, where groups of connected clients are defined. Since the interim financial statements for the first quarter of the year are not audited, the official capital is based on reviewed own fund items at 31 December 2021.

The exposure is evaluated both before and after credit risk mitigating effects. After mitigating effects, the Group currently has one large exposure. No large exposure is therefore above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects.

At 31 March 2021

Groups of connected clients:	Before	After
Group 1	66%	-
Group 2	10%	10%

At 31 December 2020

Groups of connected clients:	Before	After
Group 1	65%	-
Group 2	13%	10%

Amounts are in ISK million

Notes to the Condensed Consolidated Interim Financial Statements

50. Liquidity risk

The Group 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.

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

51. Liquidity coverage and Net stable funding ratio

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the Financial Supervisory Authority of the Central Bank's guidelines no. 2/2010 on best practices in liquidity management and liquidity coverage ratio rules no. 266/2017.

The following tables show the NSFR and the LCR for the Group at the end of March 2021 and at year-end 2020.

Net stable funding ratio	31.3.2021	31.12.2020
For all currencies	119%	123%
Foreign currencies	182%	179%

Liquidity coverage ratio	31.3.2021	31.12.2020
For all currencies	172%	196%
Domestic currency	93%	95%
Foreign currencies	235%	463%

At 31 March 2021	For all currencies		Domestic currency		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	167,331	167,331	139,187	139,187	28,144	28,144
Liquid assets level 2	32,156	8,128	31,869	8,128	287	-
Total liquid assets	199,487	175,459	171,056	147,315	28,431	28,144
Deposits	551,904	140,607	480,014	114,757	71,890	25,850
Debt issued	16,082	16,082	971	971	15,110	15,110
Other outflows	116,720	59,092	86,789	52,227	29,931	6,865
Total outflows	684,706	215,781	567,774	167,955	116,931	47,825
Short-term deposits with other banks**	102,665	100,741	2,077	2,077	100,588	98,665
Other inflows	29,472	13,093	19,396	6,831	10,076	6,262
Restrictions on inflows	-	-	-	-	(22,966)	(69,058)
Total inflows	132,137	113,834	21,473	8,908	87,698	35,869
Liquidity coverage ratio		172%		93%		235%

Amounts are in ISK million

51. Cont'd

At 31 December 2020	For all currencies		Domestic currency		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	182,104	182,104	138,078	138,078	44,027	44,027
Liquid assets level 2	14,648	2,941	14,470	2,941	178	-
Total liquid assets	196,752	185,045	152,548	141,019	44,205	44,027
Deposits	542,123	147,611	472,073	120,974	70,049	26,636
Debt issued	2,271	2,271	47	47	2,225	2,225
Other outflows	99,949	44,756	68,500	35,605	31,449	9,151
Total outflows	644,343	194,638	540,620	156,626	103,723	38,012
Short-term deposits with other banks**	88,495	88,328	2,077	2,077	86,419	86,252
Other inflows	29,842	11,981	21,342	6,221	8,500	5,760
Restrictions on inflows	-	-	-	-	(17,126)	(63,503)
Total inflows	118,337	100,309	23,419	8,298	77,793	28,509
Liquidity coverage ratio		196%		95%		463%

*Level 1 liquid assets include cash and balances with the Central Bank, domestic bonds and foreign government bonds in accordance with rules no. 266/2017 on liquidity ratio.

**Short-tem deposits with other banks with maturity less than 30 days.

Deposits by liquidity coverage ratio category

The Group's deposits are categorised by counterparty according to the Liquidity Coverage Ratio (LCR) standard. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classified as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme.

At 31 March 2021	Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	129,481	14%	248,146	5%	76,883	454,510
Operational relationships	2,762	25%	-	5%	-	2,762
Corporations	89,025	40%	2,213	20%	23,583	114,821
Sovereigns, Central Bank and public sector entities	8,993	40%	1,170	20%	21,142	31,305
Pension funds	34,344	100%	-	-	23,671	58,015
Domestic financial entities	32,228	100%	-	-	23,573	55,801
Foreign financial entities	3,542	100%	-	-	9,384	12,926
Total	300,375		251,529		178,236	730,140

At 31 December 2020	Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	120,510	14%	247,625	5%	75,971	444,106
Operational relationships	3,155	25%	-	5%	-	3,155
Corporations	77,705	40%	1,959	20%	24,965	104,629
Sovereigns, Central Bank and public sector entities	6,340	40%	1,174	20%	934	8,448
Pension funds	39,105	100%	-	-	23,754	62,859
Domestic financial entities	38,284	100%	-	-	41,647	79,931
Foreign financial entities	6,266	100%	-	-	9,819	16,085
Total	291,365		250,758		177,090	719,213

Amounts are in ISK million

52. Maturity analysis of assets and liabilities

The following tables show the maturity profile of the Group's financial assets and the undiscounted cash flows of its financial liabilities.

Maturity classification of assets is based on contractual maturity. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

The tables show undiscounted contractual payments of principal and interest for the Group'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.

The following tables also show the contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative and a positive carrying amount at the reporting date. 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.

At 31 March 2021	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	88,748	55,043	32,424	-	-	1,281	-	88,748
Loans to credit institutions	103,333	49,300	54,021	12	-	-	-	103,333
Bonds and debt instruments	103,627	-	21,034	25,949	50,102	6,542	-	103,627
Loans to customers	1,029,415	2,601	79,822	99,037	320,695	527,260	-	1,029,415
Shares and equity instruments	25,763	-	-	-	-	-	25,763	25,763
Other financial assets	16,298	14,916	761	613	8	-	-	16,298
Total financial assets	1,367,184	121,860	188,062	125,611	370,805	535,083	25,763	1,367,184
Deposits from CB and credit institutions	31,565	5,382	5,974	21,633	-	-	-	32,989
Deposits from customers	698,575	559,837	72,481	49,237	24,748	27,090	-	733,393
Debt issued and other borrowed funds	398,225	-	3,431	52,027	342,259	103,658	-	501,375
Subordinated loans	25,259	-	174	439	3,118	28,045	-	31,776
Other financial liabilities:	28,076	1,704	1,313	1,783	2,123	-	-	6,923
Lease liabilities	3,892	123	369	1,783	2,123	-	-	4,398
Other liabilities	24,184	1,581	944	-	-	-	-	2,525
Total financial liabilities	1,181,700	566,923	83,373	125,119	372,248	158,793	-	1,306,456

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	72,066	31,468	13,685	-	-	117,219
Outflow	-	(77,412)	(31,281)	(12,058)	-	-	(120,751)
Total	-	(5,346)	187	1,627	-	-	(3,532)
Net settled derivatives	-	401	-	-	-	-	401
Total derivative financial assets	-	(4,945)	187	1,627	-	-	(3,131)
Gross settled derivatives							
Inflow	-	94,860	49,817	40,588	-	-	185,265
Outflow	-	(93,203)	(51,462)	(43,923)	-	-	(188,588)
Total	-	1,657	(1,645)	(3,335)	-	-	(3,323)
Net settled derivatives	-	(4,273)	-	-	-	-	(4,273)
Total derivative financial liabilities	-	(2,616)	(1,645)	(3,335)	-	-	(7,596)
Total net financial assets and financial liabilities	(445,063)	102,360	2,324	3,519	376,289	25,763	65,192

Amounts are in ISK million

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At 31 December 2020	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	78,948	29,600	48,060	-	-	1,288	-	78,948
Loans to credit institutions	89,920	46,102	43,818	-	-	-	-	89,920
Bonds and debt instruments	128,216	-	38,169	34,776	48,047	7,224	-	128,216
Loans to customers	1,006,717	2,562	81,090	96,084	334,520	492,461	-	1,006,717
Shares and equity instruments	14,851	-	-	-	-	-	14,851	14,851
Other financial assets	3,692	2,483	560	643	6	-	-	3,692
Total financial assets	1,322,344	80,747	211,697	131,503	382,573	500,973	14,851	1,322,344
Deposits from CB and credit institutions	39,758	6,073	20,044	10,278	3,368	-	-	39,763
Deposits from customers	679,455	539,932	65,532	56,764	23,409	27,016	-	712,653
Debt issued and other borrowed funds	387,274	-	12,677	31,569	327,003	93,434	-	464,683
Subordinated loans	27,194	-	176	477	3,096	29,903	-	33,652
Other financial liabilities:	9,721	3,570	1,453	1,227	1,783	2,123	-	10,156
Lease liabilities	3,962	-	123	369	1,783	2,123	-	4,398
Other liabilities	5,759	3,571	1,330	858	-	-	-	5,759
Total financial liabilities	1,143,402	549,575	99,882	100,315	358,659	152,476	-	1,260,907

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	41,288	46,627	39,643	-	-	127,558
Outflow	-	(38,823)	(45,090)	(36,516)	-	-	(120,429)
Total	-	2,465	1,537	3,127	-	-	7,129
Net settled derivatives	-	90	-	-	-	-	90
Total derivative financial assets	-	2,555	1,537	3,127	-	-	7,219
Gross settled derivatives							
Inflow	-	29,311	18,714	29,943	-	-	77,968
Outflow	-	(30,236)	(20,113)	(33,957)	-	-	(84,306)
Total	-	(925)	(1,399)	(4,014)	-	-	(6,338)
Net settled derivatives	-	(1,752)	-	-	-	-	(1,752)
Total derivative financial liabilities	-	(2,677)	(1,399)	(4,014)	-	-	(8,090)
Total net financial assets and financial liabilities	(468,828)	117,047	34,124	31,055	348,497	14,851	76,746

Amounts are in ISK million

52. Cont'd

Off-balance sheet liabilities

The following tables show the amount of contractual obligations of off-balance sheet liabilities that the Group 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 Group'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 Group could be required to fulfil these obligations instantaneously.

At 31 March 2021	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	18,278	-	-	-	-	-	18,278
Undrawn loan commitments	60,541	-	-	-	-	-	60,541
Undrawn overdrafts	58,280	-	-	-	-	-	58,280
Credit card commitments	33,851	-	-	-	-	-	33,851
Total off-balance sheet liabilities	170,950	-	-	-	-	-	170,950
At 31 December 2020							
Financial guarantees	23,189	-	-	-	-	-	23,189
Undrawn loan commitments	40,026	-	-	-	-	-	40,026
Undrawn overdrafts	56,746	-	-	-	-	-	56,746
Credit card commitments	32,427	-	-	-	-	-	32,427
Total off-balance sheet liabilities	152,388	-	-	-	-	-	152,388

53. Market risk

The Group 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, foreign exchange rates, equity prices, CPI-indexation and commodity prices. Sources of market risk are imbalances in the Group's balance sheet and open positions in bonds, currencies and equities. Derivative contracts are also potential sources of market risk.

Market risk within the Group can broadly be split into two categories, trading book and banking book. The trading book includes market risk exposures related, directly or indirectly, to the Group's short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. 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. The banking book includes market risk exposures related to securities held for long-term investment purposes, unlisted securities or holdings in subsidiaries or affiliates. A large part of the banking book market risk is due to mismatches in the composition of assets and liabilities, for example with respect to currencies, interest rates, CPI-indexation or other factors that can affect the Group's earnings or earnings volatility. These mismatches are reported to management and are subject to internal and regulatory limits.

54. Interest rate risk

Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates. Sensitivity measures like Basis Point Value (BPV) are used 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.

Amounts are in ISK million

54. Cont'd

Interest rate risk in the trading book

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing and Construction Authority which are guaranteed by the Icelandic Government, domestic municipality bonds, and covered bonds issued by other Icelandic banks. Bonds and bills in the Group's liquidity portfolio are also categorised in the trading book. In the following table the total market value (MV) of long and short positions may not be the same as reported in Note 16 since netting between short and long positions is not applied here.

	31.3.2021			31.12.2020		
Trading bonds and debt instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	4,222	1.93	(0.81)	4,103	1.87	(0.77)
Non-indexed	64,528	0.82	(5.30)	86,829	0.66	(5.70)
Total	68,750	0.89	(6.11)	90,932	0.71	(6.47)

	31.3.2021			31.12.2020		
Trading bonds and debt instruments, short positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	5	2.00	-	224	6.00	0.12
Non-indexed	136	5.00	0.07	351	5.00	0.17
Total	141	4.89	0.07	575	5.39	0.29
Net position of trading bonds and debt instruments	68,609	0.88	(6.04)	90,357	0.68	(6.18)

Interest rate risk in the banking book

Interest rate risk in the banking book arises from the Group'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 Group's assets and liabilities are of different maturities and are priced relative to different interest rates.

The following table shows the interest sensitivity of the Group's banking book from a parallel 100 basis points change in all yield curves, with all other variables held constant, categorised by the date of next interest rate reset.

Sensitivity analysis for interest rate risk in the banking book

At 31 March 2021

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	(1)	(98)	188	(2,844)	4,206	(1,042)	409
ISK, non-indexed	(32)	(14)	(59)	(1,201)	278	(5)	(1,033)
EUR	25	(101)	(793)	911	-	(1)	41
SEK	21	-	-	-	-	-	21
USD	1	12	-	-	-	(1)	12
Other	11	(5)	-	(9)	-	(6)	(9)
Total	25	(206)	(664)	(3,143)	4,484	(1,055)	(559)

At 31 December 2020

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	-	(108)	236	(2,554)	4,388	(1,232)	730
ISK, non-indexed	(13)	(28)	(43)	(945)	(218)	(4)	(1,251)
EUR	60	(58)	(34)	123	-	(1)	90
SEK	(5)	-	-	-	-	-	(5)
USD	27	-	-	-	-	(1)	26
Other	(2)	(12)	-	(8)	-	(6)	(28)
Total	67	(206)	159	(3,384)	4,170	(1,244)	(438)

Amounts are in ISK million

55. Currency risk

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 Group'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.

Series C preferred shares in Visa Inc., which the Group holds, are included in the currency imbalance even though the shares are classified as held for sale.

At 31 March 2021	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	596	281	143	39	15	55	57	99	29	126	1,440
Loans to credit institutions	31,232	29,043	1,981	292	198	12,270	24,784	515	143	37	100,495
Bonds and debt instruments	14,095	3,789	9	-	-	2,896	5,924	-	-	-	26,713
Loans to customers	126,090	33,960	1,136	989	3,039	72	3,215	2,760	3,752	26	175,039
Shares and equity instruments	134	1,502	339	-	-	191	5	-	-	-	2,171
Other assets	3,506	475	2	-	-	67	-	-	-	-	4,050
Total assets	175,653	69,050	3,610	1,320	3,252	15,551	33,985	3,374	3,924	189	309,908
Deposits from credit institutions	8,501	529	25	-	-	-	8	1	-	-	9,064
Deposits from customers	33,258	27,726	4,910	438	320	958	2,952	1,829	417	29	72,837
Derivative instruments and short positions	1	-	-	-	-	9	-	-	-	-	10
Debt issued and other borrowed funds	135,690	-	-	-	-	38,368	34,165	-	-	-	208,223
Subordinated loans	-	-	-	-	-	25,259	-	-	-	-	25,259
Other liabilities	1,674	462	1	-	-	42	-	-	-	70	2,249
Total liabilities	179,124	28,717	4,936	438	320	64,636	37,125	1,830	417	99	317,642
Net on-balance sheet position	(3,471)	40,333	(1,326)	882	2,932	(49,085)	(3,140)	1,544	3,507	90	(7,734)
Net off-balance sheet position	3,992	(37,293)	1,433	(887)	(2,922)	49,037	3,056	(1,533)	(3,519)	(59)	11,305
Net position	521	3,040	107	(5)	10	(48)	(84)	11	(12)	31	3,571

Amounts are in ISK million

55. Cont'd

At 31 December 2020	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	779	281	148	45	17	54	56	101	31	119	1,631
Loans to credit institutions	28,586	44,519	1,301	422	248	880	9,487	415	375	100	86,333
Bonds and debt instruments	25,052	3,932	7	-	-	3,894	11,195	-	-	-	44,080
Loans to customers	127,317	31,584	1,160	521	3,330	84	3,215	2,788	7,468	29	177,496
Shares and equity instruments	32	1,551	338	-	-	152	32	-	-	-	2,105
Other assets	606	124	-	-	-	34	-	-	3	-	767
Total assets	182,372	81,991	2,954	988	3,595	5,098	23,985	3,304	7,877	248	312,412
Deposits from credit institutions	10,958	788	23	-	-	-	1	-	-	-	11,770
Deposits from customers	26,757	30,607	3,917	517	386	1,017	3,132	2,277	392	20	69,022
Derivative instruments and short positions	-	-	-	-	-	9	-	-	-	-	9
Debt issued and other borrowed funds	143,255	-	-	-	-	38,589	21,169	-	-	-	203,013
Subordinated loans	-	-	-	-	-	27,194	-	-	-	-	27,194
Other liabilities	415	114	-	-	-	19	-	29	1	-	578
Total liabilities	181,385	31,509	3,940	517	386	66,828	24,302	2,306	393	20	311,586
Net on-balance sheet position	987	50,482	(986)	471	3,209	(61,730)	(317)	998	7,484	228	826
Net off-balance sheet position	463	(46,840)	920	(484)	(3,198)	61,672	268	(829)	(7,468)	(276)	4,228
Net position	1,450	3,642	(66)	(13)	11	(58)	(49)	169	16	(48)	5,054

Amounts are in ISK million

56. Inflation risk

The Group is exposed to inflation risk since the value of CPI-linked assets exceeds CPI-linked 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 affect profit and loss. A 1% increase in the index would lead to an ISK 251 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

	31.3.2021	31.12.2020
Bonds and debt instruments	4,927	4,684
Loans to customers	264,165	268,062
Total CPI-linked assets	269,092	272,746
Deposits from customers	92,404	90,353
Debt issued and other borrowed funds	135,527	136,487
Off-balance sheet exposures	16,025	19,725
Total CPI-linked liabilities	243,956	246,565
CPI imbalance	25,136	26,181

57. Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. However, the Group is subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and collateral requirements. Other derivatives held for trading or for other purposes are insignificant.

58. Capital management

The following tables show the capital base, the risk exposure amount, the resulting capital ratios, and the leverage ratio for the Group at 31 March 2021 and 31 December 2020.

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through Act no. 161/2002 on Financial Undertakings and regulation no. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

EU regulation no. 2017/2395 regarding transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds, was ratified into Icelandic law in May 2020. The regulation allows for the phasing in of capital impacts due to IFRS 9, allowing institutions to include a predefined level of provisions as part of CET1 capital. Íslandsbanki has elected to make use of the transitional arrangements, which will add ISK 3.8 billion to CET1, corresponding to an increase of 40 basis points in the Group's capital ratio.

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the Financial Supervisory Authority of the Central Bank, applicable as of 22 September 2020, the overall capital requirement is 17.0%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The minimum leverage ratio for Icelandic financial institutions is 3%.

Amounts are in ISK million

58. Cont'd

	31.3.2021	31.12.2020
CET1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,353	6,181
Retained earnings	113,335	113,529
Non-controlling interests	783	1,494
IFRS 9 reversal due to transitional rules	3,853	5,164
Fair value changes due to own credit standing	434	238
Expected or proposed dividend payment	(1,725)	-
Tax assets	(1,087)	(259)
Intangible assets	(3,357)	(3,478)
Total CET1 capital	183,589	187,869
Tier 2 capital		
Qualifying subordinated loans	25,259	27,194
Total capital base	208,848	215,063
Risk exposure amount		
- due to credit risk	851,309	830,141
- due to market risk	17,447	16,626
Market risk, trading book	14,062	11,306
Currency risk	3,385	5,320
- due to credit valuation adjustment	930	1,728
- due to operational risk	85,026	85,026
Total risk exposure amount	954,712	933,521
Capital ratios		
Tier 1 ratio	19.2%	20.1%
Total capital ratio	21.9%	23.0%
Leverage ratio		
Exposure amount		
On-balance sheet exposures	1,378,255	1,333,807
Off-balance sheet exposures	68,366	41,067
Derivative exposures	6,611	9,922
Leverage ratio total exposure measure	1,453,232	1,384,797
Tier 1 capital	183,589	187,869
Leverage ratio	12.6%	13.6%

Amounts are in ISK million

Íslandsbanki

Consolidated Financial Statements 2020

The audited consolidated financial statements of Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) for the year 2020 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Group".

Operations in 2020

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share. The vision is to make Íslandsbanki #1 for service.

The profit from the Group's operations for the year 2020 amounted to ISK 6,755 million, which corresponds to 3.7% return on equity. The Board of Directors proposes that ISK 3.4 billion will be paid in dividends to shareholders, which is 50% of profits in 2020 and is in line with the Bank's policy of paying dividends of 40-50% of the profit of the year. The Board may convene a special shareholders' meeting later in the year to propose payment of additional dividends if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements. Due to uncertainties regarding the impact of the COVID-19 pandemic on the Icelandic economy and views expressed by the Icelandic government and regulator, the Bank did not pay any dividends in 2020. At year-end 2020 the Group employed 779 full-time members of staff, including 745 within the Bank itself, 57% female and 43% male.

Net interest income increased by 1.7% between years, as the balance sheet growth is somewhat offset by a lower interest environment, resulting in a drop of 0.1 percentage points in the net interest margin. Net fee and commission income was down by 3.4%. Other net operating income was an ISK 743 million loss due to negative net financial income. Administrative expenses were down by 7.1% between years. Salary costs were down by 7.9% as the number of FTE's reduced. Other operating expenses decreased by 6.1% and there was also a substantial reduction in both the Bank tax and the contribution to the Depositors' and Investors' Guarantee Fund. Net impairments were negative by ISK 8.8 billion. The large increase in the cost of risk almost entirely related to the impact of the COVID-19 pandemic on the corporate loan book.

The balance sheet of the Group grew by 12.1% between years following a 11.9% growth in loans to customers, due to a 28% increase in loans to individuals. The increased market share in mortgages was partly the result of the lower interest rate environment and reduced lending presence from pension funds. The ratio of non-performing loans decreased from 3.0% to 2.9% during the year. Loans in stage 2 under IFRS-9 increased from 2.6% to 15.6%, as most exposures to the tourism sector evidenced an increased risk of default and are in many cases subject to forbearance measures due to the COVID-19 pandemic.

Deposits from customers increased by 9.9% in 2020, driven by growth in all business units, where the biggest growth of 24.5% was in Corporate and Investment Banking. The Bank was successful overall in its funding operations in 2020. Covered bonds amounting to ISK 30.9 billion were issued through regular auctions throughout the year. In late April 2020 S&P lowered the Bank's rating to BBB/A-2 with a stable outlook from previous BBB+/A-2 with a negative outlook. The other large Icelandic banks were downgraded at the same time and in all cases the downgrade was reasoned to be due to weaker business prospects and the effect of the COVID-19 pandemic.

The Group's total equity amounted to ISK 186.2 billion and total assets were ISK 1,344.2 billion at year-end and the Group's total capital ratio was 23%. The Bank's regulatory capital requirement was reduced in 2020 as the countercyclical buffer was lowered from 2.0% to zero, as a result of economic uncertainties relating to the COVID-19 pandemic. The current capital requirement is therefore 17.0% and well below the Bank's capital ratio. The Bank's liquidity position remains strong and well above regulatory requirements.

The COVID-19 pandemic has been the main theme of the year, both due to the impact on many of the Bank's customers and also on the operations of the Bank itself. Our employees have worked from home large parts of the year, which has not affected efficiency and we saw record positive numbers in the annual staff satisfaction survey. As the period of limited personal interactions continues to lengthen, it can however be expected that staff members start to show strain and a strong hope for a new normal, where they can spend at least 3-4 days a week in the office.

The COVID-19 pandemic has also had a dramatic impact on branch openings, and we have seen a large uptake in the use of other service channels. Visits to branches have declined by over 70% in the past few years. Concurrent with these changes, the branches at Höfði and Grandi have been merged with the Laugardalur branch. After the merger, the Bank will operate three branches in the capital area.

Íslandsbanki has in 2020 put an even stronger focus than before on sustainability. In the fourth quarter Íslandsbanki was the first bank in Iceland to publish a Sustainable Financing Framework. Based on this new framework, the Bank also became the first bank in Iceland to issue sustainable bonds. Firstly, a EUR 300 million sustainable benchmark bond was issued internationally and was close to four times oversubscribed. Secondly, an ISK 2.7 billion domestic green bond was sold to Icelandic investors. The Bank has begun to make use of these funds and extended its first green loan in December 2020.

Outlook

The Icelandic economy was unavoidably hard hit by the COVID-19 pandemic in 2020, given the size of its tourist sector as share of both export revenues and the labour market. Gross domestic product (GDP) contraction in 2020 looks likely to prove over 8%, making the year the worst in this regard in Iceland's modern economic history. Around 2/3 of the GDP fall is due to declining exports and 1/3 caused by a fall in domestic demand. However, economic policy has mitigated the impact on households and businesses considerably as monetary conditions have been eased and fiscal spending substantially increased to facilitate support measures for the afflicted sector and boost public investment.

As a result, the rise in defaults and bankruptcies has been more muted than feared and the majority of Icelandic households have been spared a significant fall in disposable income.

The duration of the economic setback will hinge on how rapidly travel conditions normalise and global economic activity resumes. The rapid process of the development and rollout of vaccines so far has gradually increased the upside potential for economic rebound in Iceland. Assuming fading impact from the COVID-19 pandemic over the coming months, there is a good probability of a return to healthy GDP growth in the latter half of 2021. The Bank's Chief economist expects GDP growth to average 3.2% in 2021, driven by increasing exports as well as a boost to public investment and moderate consumption growth. For 2022, the expected 5.0% GDP growth will be largely driven by increasing domestic demand.

There is still considerable uncertainty regarding the overall impact of the COVID-19 pandemic on the tourism industry in Iceland and especially whether visitor numbers will pick up rapidly in 2021. Supporting the Bank's customers through this recession will remain the key focus for the coming months. As the economy improves, the focus will shift more towards improving profitability and managing both the cost base and growth in the balance sheet and revenue. The work environment for the Bank's employees can be expected to move towards a new normal, where employees spend a part of the week working from home. The Bank's financial strength has remained robust throughout the recent economic challenges and the Bank is well placed to continue to be #1 for service for its customers.

Risk management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations and the Bank has focused on building up a responsible internal risk culture among the Bank's employees. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies and the CEO is responsible for ensuring that risks are managed within those limits.

The Board hereby declares that Íslandsbanki has an overall satisfactory risk management in relation to the Bank’s profile and strategy.

The Bank's risk management framework and policies are discussed under Notes 46-66 to the consolidated financial statements and in the unaudited Pillar 3 Report.

Ownership

The Bank is wholly owned by the Icelandic Government and there were no changes in the ownership in 2020. The shares are administered by the Icelandic State Financial Investments (ISFI) in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Icelandic Government published in February 2020 an updated general ownership policy for financial institutions with regards to ownership stakes administered with the Icelandic State Financial Investments (ISFI). In December 2018 the Bank signed an agreement with ISFI on general and specific goals for the operations, in line with article 2.3 of the ownership policy.

The Minister of Finance and Economic Affairs has made a formal decision to initiate the process of the sale of shares in Íslandsbanki in accordance with the ISFI (Icelandic State Financial Investments) proposal dated 17 December 2020. The ISFI is tasked with preparing Íslandsbanki for a listing on a local regulated stock market and the consequent sale of shares in a public offering (IPO) with the aim of a distributed ownership and the minimum of 25% of shares and a maximum of 35% of shares to be sold.

Corporate governance

The Board of Directors of Íslandsbanki is committed to excellence in its governance framework so that it complies with the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as “Exemplary in Corporate Governance” in March 2014. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition has been renewed annually since and is now granted by Stjórnvísi.

The Board of Directors comprises seven non-executive directors and one alternate member. The Board undertakes the Bank's affairs and is responsible for setting the Bank's general strategy as well as instructing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with relevant laws, regulations and good business practices. Furthermore, the Board shall monitor the execution of its policies, the sound control of accounting and financial management, and ensure that group internal audit, compliance, risk management and internal controls are effective at all times.

Candidates for board membership are nominated through a selection process administered by the Icelandic State Financial Investments in accordance with Article 7 of the ISFI Act no. 88/2009. At the Bank's Annual General Meeting in March the Board of Directors was elected for the Bank. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board consists of seven members, four female and three male.

The Board has approved a policy on the suitability of the Board of Directors, the CEO and key function holders. The policy states, among other things, that the composition of the Board shall at any time be diverse, with regard to educational and professional background, gender and age.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of Board subcommittees are available on the Bank's website.

The CEO is responsible for the day-to-day operations of the Bank and that the Bank's business is, at all times, in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Committee and other Senior Management Committees.

The Executive Committee, comprising seven members, including the CEO, is composed of three women and four men. The role of the Executive Committee is to maintain an overall view of the Bank's operations and to coordinate key aspects of its activities that are not supervised by other senior management committees. The CEO ensures that the Board is regularly provided with accurate information on the Bank's finances, development and operations.

The Bank's Finance division is responsible for the preparation of the Group's consolidated financial statements which are prepared in accordance with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review the second quarter interim consolidated financial statements and audit annual consolidated financial statements.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to its operations, including those imposed by the Central Bank of Iceland and Nasdaq Iceland. The applicable laws include, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Public Limited Companies no. 2/1995 and the Act on Competition no. 44/2005, available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is (hereinafter the Guidelines). The Bank's practices are compliant with the guidelines except for Article 1.5. Article 1.5 of the Guidelines provides that the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by ISFI in accordance with article 7 of the ISFI Act.

A more detailed description of Íslandsbanki's governance framework and associated practices can be found in the Bank's Corporate Governance Statement enclosed in an unaudited Appendix to the consolidated financial statements and on the Bank's website, www.islandsbanki.is.

Sustainability

Íslandsbanki's Sustainability Policy was approved by its board in late 2019. The Policy aims at making the Bank a model of exemplary operations in the Icelandic business community, based on internationally recognised environmental, social, and governance (ESG) criteria. The ESG criteria are a set of references used by investors to evaluate investments based on responsible investment methodology.

The Bank aims to be a leader in the area of sustainable development and a catalyst for positive social action, moving Iceland forward by empowering its customers to succeed. To this end, the Bank intends to initiate broad collaboration on responsible business practices that both contribute to sustainable development in the Icelandic economy and support the Government's Climate Action Plan, while also supporting the UN SDGs.

Alongside its vision of being a leader in service to customers, the Bank will focus on integrating sustainability considerations into its activities, in addition to its profit objectives. The Bank will take account of ESG criteria in its risk management and will explore opportunities to take advantage of green investment opportunities. Íslandsbanki aims to increase the general public's financial knowledge and interest in the subject and, to this end, it offers interesting and accessible seminars on finance and economics.

Íslandsbanki's Sustainability Policy creates a comprehensive framework for its activities in the area of environmental affairs, respect for human rights, responsible lending, investments, purchasing, and grants, as well as integrating with and supporting the Bank's other policies. Íslandsbanki sets quantifiable ESG targets in its operations and discloses its performance relative to targets, in accordance with the Nasdaq ESG Guidelines and relevant GRI standards, in a separate report issued concurrent with the Bank's annual financial statements. When calculating the Bank's carbon footprint, all greenhouse gas (GHG) emissions for its operations were examined, whether direct emissions from its procedures or emissions from employees, suppliers, contractors or customers. Reported emissions are divided into scopes 1, 2 and 3. Íslandsbanki's Sustainability Report for the year 2020 was reviewed and signed by Klappir Green Solutions. The report is based on information collected by the company's environmental software, EnviroMaster, throughout the year. The Sustainability Report includes the key information on the environmental, social and governance criteria for Íslandsbanki in accordance with the Nasdaq ESG guidelines from 2019.

Íslandsbanki has in place a Code of Conduct for employees and the Board of Directors which is available on the Bank's website and in addition the Bank's Sustainability Policy emphasises these matters. The Code's aim is to promote good operational practices, reporting of misconduct and actions to prevent conflict of interest. Employees confirm annually that they have read and understood the rules and commit their adherence to the rules, and at the end of 2020 more than 99% of employees had confirmed the rules. Moreover, the Bank has in place an extensive policy on actions against money laundering and terrorist financing. The Bank emphasises respect for human rights and avoids business transactions where human rights are violated, including discrimination on the basis of gender, religion, or race according to the Sustainability Policy and the Code of Conduct for suppliers.

As a signatory to the UN Global Compact, Íslandsbanki is committed to aligning its operations and strategies with 10 principles covering human rights, labour, the environment and anti-corruption. In 2020, the Bank joined the UN Principles for Responsible Banking, which provide a framework for a sustainable banking system, and help the industry to demonstrate how it makes a positive contribution to society and build on the following six principles: Alignment, Impact and Target Setting, Clients and Customers, Stakeholders, Governance and Culture, and Transparency and Accountability. The Bank has in place a Code of Conduct and a Conflict of Interest Policy in order to ensure creditability in business transacted by the Bank and its clients and employees' impartiality in handling and processing individual cases. The Bank has in place a Code of Conduct for Suppliers, approved in June 2020, which are based on ESG criteria. The Bank is committed to engage in active dialogue with its suppliers on enhancing their focus on sustainable business practices. In October 2020, Íslandsbanki became the first Icelandic bank to develop and publish a Sustainable Financing Framework for sustainable loans in its portfolio, with a second party opinion from Sustainalytics. This enabled the Bank to issue the first sustainable and green bonds by an Icelandic bank in late 2020.

In line with the Policy, the Bank has approved seven sustainability goals for its operations, to be completed by 2025. The goals are based on ESG criteria and include among others plans for the Bank to become carbon neutral in its operations, thereof reducing carbon emissions by 50% from 2019 to year-end 2024. The goals are supported by annual targets set by business units as part of their 5-year planning process. The Bank joined in 2020 a coalition of other banks, that are developing a methodology to measure carbon emissions from its lending and investment operations, called the Partnership for Carbon Accounting Financials (PCAF).

During the year the Board of Directors approved an updated version of the Risk Appetite Statement and for the first-time sustainability risk is discussed. One of the Bank's seven sustainability goals is to measure and publish on the sustainability risk and strengthen the sustainability frame. This is emphasis is reflected in the Bank's unaudited Pillar 3 Report 2020 which has a chapter on sustainability and climate risk adhering to international TCFD (Task Force on Climate-related Financial Disclosures) criteria.

The Board of Directors has approved the Sustainability Policy and sets the Bank's strategy and risk appetite in terms of sustainability risk. The Board is regularly updated on corporate sustainability matters and the usage of the Bank's Sustainable Financing Framework. The Corporate Governance and Human Resource subcommittee of the Board assists the Board in fulfilling its oversight responsibilities concerning sustainability.

The CEO is responsible for executing the strategy and has appointed a Sustainability Committee as a main building block of the governance structure. The Committee is the formal forum for discussions on all issues related to sustainability risk, sustainable procurement and business opportunities. The Committee is independent from credit committees and needs to approve proposals for credit cases before they are included in the Sustainable Financing Framework. The Committee has senior representatives from business units, Finance and Risk Management.

The Bank's sustainability and ESG factors are further described in the unaudited annual and sustainability report and the Bank's unaudited Pillar 3 report for the year 2020.

Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2020 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2020 and its financial position as of 31 December 2020. Furthermore, in our opinion the financial statements and the Director's report give fair view of the main operational developments and achievements and describe the principal risks and uncertainties that the Group faces in its operations.

The Board of Directors and the CEO have today discussed and approved the 2020 Consolidated Financial Statements of Íslandsbanki.

Kópavogur, 10 February 2021

Board of Directors:
Hallgrímur Snorrason, Chairman
Heiðrún Jónsdóttir, Vice-Chairman
Anna Þórðardóttir
Árni Stefánsson
Frosti Ólafsson
Guðrún Þorgeirsdóttir
Herdís Gunnarsdóttir

Chief Executive Officer:
Birna Einarsdóttir

Independent Auditor's Report

To the Board of Directors and shareholders of Íslandsbanki hf.

Opinion

We have audited the consolidated financial statements of Íslandsbanki hf. and its subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2020 and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2020, and its consolidated financial performance and its consolidated cash flows for the year then ended, in accordance with the International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

Our opinion in this report on the consolidated accounts are consistent with the content of the additional report that has been submitted to the parent company's audit committee in accordance with the Audit Regulation (537/2014) Article 11.

Basis for Opinion

We conducted our audit in accordance with the International Standards on Auditing (ISAs). Our responsibilities are further described in the Auditor's Responsibilities for the Audit of the financial statements section of our report. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Independence

We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the consolidated financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code.

To the best of our knowledge, we have not provided any prohibited non-audit services as described in article 5(1) of Regulation (EU) no. 537/2014.

Appointment of auditor

We were initially appointed as auditor of Íslandsbanka hf. on 25 March 2015 for the financial year 2015 and we have been reappointed every year since then.

Key Audit Matters

Key Audit Matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole and in forming our opinion thereon. We do not provide a separate opinion on these matters.

We have fulfilled our responsibilities described in the "Auditor's responsibilities for the audit of the financial statements" section, including in relation to the key audit matters below. Accordingly, our audit included the design and performance of procedures to respond to our assessment of the risks of material misstatement of the financial statements. The results of our audit procedures, including the procedures performed to address the matters below, provide the basis for our audit opinion on the financial statements.

Why significant	How our audit addressed the Key Audit Matter
Provision for expected credit losses (ECL)	

Loans to customers represent ISK 1,006,717 million or 75% of total assets at 31 December 2020 against which impairment allowances of ISK 17,514 million have been recorded.
 	
There is significant uncertainty about the economic impact of the COVID-19 pandemic and the impact on expected credit losses, in particular due to loans to customers in the tourism and related industries.
 	
The determination of the provision for credit impairment is based on estimates and judgement by management. Key areas of judgement include:
- management overlays and assumptions related to the economic effects of the COVID-19 pandemic;
- the interpretation of the requirements to determine impairment under application of IFRS 9, which is reflected in the Group's expected credit loss model;
- the identification of loans with significant deterioration in credit quality;
- assumptions used in the expected credit loss model such as the financial condition of the counterparty, expected future cash flows and forward-looking macroeconomic factors.
 	
Due to the use of judgement and estimates, in particular due to the COVID-19 pandemic, and the relative size of loans to customers on the balance sheet, we consider the provision for credit impairment a Key Audit Matter.
	Our procedures focused on the following to respond to the Key Audit Matter, among others:
	- Assessing the Group's expected credit loss model, focusing on the following areas:
	  - alignment of the expected credit loss model and its underlying methodology with the requirements of IFRS 9;
	  - approach to the incorporation of forward-looking macroeconomic factors;
	  - management overlays and assumptions related to the economic effects of COVID-19 pandemic on the expected credit loss model;
	- Testing the effectiveness of relevant controls relating, among others, to the:
	  - data used to determine the provision for credit impairment, including transactional data captured at loan origination and ongoing internal credit quality assessment;
	  - expected credit loss model, including model build and approval, ongoing monitoring/validation, model governance and mathematical accuracy;
	  - review and approval of forward-looking macro-economic factors; and
	  - registration and valuation of collateral used in the calculation of expected credit loss.
	- Testing of a sample of loans and procedures to evaluate among others:
	  - timely identification of loans with significant deterioration in credit quality;
	  - expected loss calculation by re-performing and assessing the reasonableness of the ECL model calculations;
	  - appropriateness of forward-looking macroeconomic factors; and
	  - COVID-19 pandemic effects of a sample of borrowers in the tourism and related industries and impact on collateral.
	
	In addition, we assessed the adequacy of the disclosures in the consolidated financial statements. Refer to Notes 3 and 67.4 for credit impairment.

Why significant	How our audit addressed the Key Audit Matter
Reliability of information from IT systems relevant to financial reporting	
The Group is highly dependent on IT systems due to the significant number of transactions that are processed daily and the complexity of the various systems used by the Group. In the process of preparing the consolidated financial statements the Group uses data from many complex IT systems. The reliability of the data, among others, the accuracy and completeness, is important to support the reliability of financial reporting. Because of the importance of the data from the IT systems supporting the financial reporting we consider their reliability a Key Audit Matter.	Our procedures focused on the following to respond to the Key Audit Matter, among others: ▸ Obtained an understanding of the Group's IT systems and the IT-environment relevant for financial reporting. ▸ Reviewed the design, implementation and effectiveness of control activities, as appropriate, related to change management, access management and computer operations for the systems considered important for the audit. ▸ For those systems, considered important in the audit and are outsourced, we obtained and assessed the ISAE 3402 report which is issued by the services organisation and reviewed by an independent auditor. IT specialists were involved in the audit.

We have fulfilled our responsibilities described in the "Auditor's responsibilities for the audit of the consolidated financial statements" section, including in relation to the Key Audit Matters above. Accordingly, our audit included the design and performance of procedures to respond to our assessment of the risks of material misstatement of the consolidated financial statements. The results of our audit procedures, including the procedures performed to address the matters above, provide the basis for our audit opinion on the consolidated financial statements.

Other information

This document also contains other information than the consolidated financial statements and our auditor's report thereon. The other information is: The unaudited highlights, Directors´ Report, unaudited quarterly statements in Note 7 and unaudited Íslandsbanki's Corporate Governance Statement 2020 in appendix. Management and Board of Directors are responsible for the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon except for confirmation regarding Directors' Report as stated below.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether it is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we, based on the work we have performed concerning this other information, conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of CEO and Board of Directors for the consolidated financial statements

The Chief Executive Officer (CEO) and Board of Directors are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

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

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors is responsible for overseeing the Group's consolidated financial reporting process.

Auditor's Responsibilities for the Audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with International Standards on Auditing

(ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with the International Standards on Auditing (ISAs), we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the Key Audit Matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on the Board of Directors Report

Pursuant to the legal requirements of Article 104, Paragraph 2 of the Icelandic Financial Statement Act no. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the consolidated financial statements includes all information required by the Icelandic Financial Statement Act.

Reykjavík, 10 February 2021

Margrét Pétursdóttir
State Authorised Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Consolidated Income Statement

	Notes	2020	2019
Interest income*		55,695	61,965
Interest expense		(22,324)	(29,143)
Net interest income	8	33,371	32,822
Fee and commission income		12,651	12,052
Fee and commission expense		(2,126)	(1,153)
Net fee and commission income	9	10,525	10,899
Net financial expense	10	(1,391)	(820)
Net foreign exchange gain	11	451	139
Other operating income	12	197	2,125
Other net operating income		(743)	1,444
Total operating income		43,153	45,165
Salaries and related expenses	13	(12,917)	(14,019)
Other operating expenses	14	(9,829)	(10,469)
Contribution to the Depositors' and Investors' Guarantee Fund		(679)	(936)
Bank tax	67.20	(1,588)	(3,528)
Total operating expenses		(25,013)	(28,952)
Profit before net impairment on financial assets		18,140	16,213
Net impairment on financial assets	15	(8,816)	(3,480)
Profit before tax		9,324	12,733
Income tax expense	16	(2,472)	(3,909)
Profit for the year from continuing operations		6,852	8,824
Discontinued operations, net of income tax	17	(97)	(370)
Profit for the year		6,755	8,454
Profit attributable to shareholders of Íslandsbanki hf.		7,061	8,809
Loss attributable to non-controlling interests		(306)	(355)
Profit for the year		6,755	8,454
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	18	0.72	0.92

*Of which interest income amounting to ISK 53,378 million (2019: ISK 59,289 million) is calculated using the effective interest method.

Before its sale on 7 July 2020, the subsidiary Borgun hf. was classified as disposal group held for sale and as discontinued operations, accordingly the comparative figures have been restated (see Note 5).

The notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 11 Amounts are in ISK million

Consolidated Statement of Comprehensive Income

	2020	2019
Profit for the year	6,755	8,454
Net gain on financial assets	114	1,272
Net gain (loss) on financial liabilities	108	(677)
Items that will not be reclassified to the income statement	222	595
Foreign currency translation	(329)	-
Items that may subsequently be reclassified to the income statement	(329)	-
Other comprehensive income (expense) for the year, net of tax	(107)	595
Comprehensive income for the year	6,648	9,049
Total comprehensive income attributable to shareholders of Íslandsbanki hf.	7,492	8,939
Total comprehensive income (expense) attributable to non-controlling interests	(844)	110
Total comprehensive income for the year	6,648	9,049

The notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 12 Amounts are in ISK million

Consolidated Statement of Financial Position

	Notes	31.12.2020	31.12.2019
Assets			
Cash and balances with Central Bank	23	78,948	146,638
Loans to credit institutions	24	89,920	54,376
Bonds and debt instruments	19	128,216	52,870
Derivatives	25	6,647	5,621
Loans to customers	26	1,006,717	899,632
Shares and equity instruments	19	14,851	18,426
Investments in associates	28	775	746
Property and equipment	29	7,341	9,168
Intangible assets	30	3,478	4,330
Other assets	31	4,125	6,608
Non-current assets and disposal groups held for sale	32	3,173	1,075
Total Assets		1,344,191	1,199,490
Liabilities			
Deposits from Central Bank and credit institutions	33	39,758	30,925
Deposits from customers	34	679,455	618,313
Derivative instruments and short positions	25	6,936	6,219
Debt issued and other borrowed funds	36	387,274	306,381
Subordinated loans	37	27,194	22,674
Tax liabilities	39	5,450	7,853
Other liabilities	40	11,920	27,063
Total Liabilities		1,157,987	1,019,428
Equity			
Share capital		10,000	10,000
Share premium		55,000	55,000
Reserves		6,181	7,065
Retained earnings		113,529	105,569
Total Shareholders' Equity		184,710	177,634
Non-controlling interests		1,494	2,428
Total Equity		186,204	180,062
Total Liabilities and Equity		1,344,191	1,199,490

The notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 13 Amounts are in ISK million

Consolidated Statement of Changes in Equity

	Share capital	Share premium	Statutory reserve	Restricted reserves	Fair value reserve	Liability credit reserve	Foreign currency translation reserve	Retained earnings	Total shareholders' equity	Non-controlling interests	Total equity
Equity as at 1.1.2020	10,000	55,000	2,500	3,525	1,432	(392)	-	105,569	177,634	2,428	180,062
Profit (loss) for the year								7,061	7,061	(306)	6,755
Net gain (loss) on financial assets					(860)			1,392	532	(418)	114
Net gain (loss) on financial liabilities						154		(46)	108		108
Foreign currency translation							(209)		(209)	(120)	(329)
Restricted due to capitalised development costs				(291)				291	-		-
Restricted due to fair value changes				282				(282)	-		-
Restricted due to associates				40				(40)	-		-
Changes due to IFRS 15								(115)	(115)		(115)
Changes in non-controlling interests								(301)	(301)	(90)	(391)
Equity as at 31.12.2020	10,000	55,000	2,500	3,556	572	(238)	(209)	113,529	184,710	1,494	186,204
Equity as at 1.1.2019	10,000	55,000	2,500	3,750	625	(376)	-	102,496	173,995	2,318	176,313
Profit (loss) for the year								8,809	8,809	(355)	8,454
Dividends paid								(5,300)	(5,300)		(5,300)
Net gain on financial assets					807				807	465	1,272
Net loss on financial liabilities						(16)		(661)	(677)		(677)
Restricted due to capitalised development costs				(551)				551	-		-
Restricted due to fair value changes				308				(308)	-		-
Restricted due to subsidiaries and associates				18				(18)	-		-
Equity as at 31.12.2019	10,000	55,000	2,500	3,525	1,432	(392)	-	105,569	177,634	2,428	180,062

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At year-end 2020 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank. The Bank has one class of ordinary shares which carry no right to fixed income. The Annual General Meeting ("AGM") for the operating year 2019 was held on 19 March 2020. At the AGM shareholders approved the Board’s proposal that dividends to shareholders for the operating year 2019 shall not be paid based on the current economic environment.

The notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 14 Amounts are in ISK million

Consolidated Statement of Cash Flows

	Notes	2020	2019
Profit for the year		6,755	8,454
Non-cash items included in profit for the year*		28,780	24,324
Changes in operating assets and liabilities*		(109,535)	(7,998)
Dividends received		30	46
Income tax and bank tax paid		(6,754)	(6,493)
Net cash (used in) provided by operating activities		(80,724)	18,333
Net investment in a subsidiary		(2,176)	-
- thereof proceeds from sale of a subsidiary		2,384	-
- thereof cash and cash equivalents owned by a subsidiary sold during the year		(4,560)	-
Proceeds from sales of property and equipment		24	21
Purchase of property and equipment		(552)	(327)
Purchase of intangible assets		(260)	(246)
Net cash used in investing activities		(2,964)	(552)
Proceeds from borrowings		80,778	112,105
Repayment and repurchases of borrowings		(33,673)	(114,708)
Repayment of lease liabilities		(390)	(378)
Dividends paid		-	(5,300)
Net cash provided by (used in) financing activities		46,715	(8,281)
Net increase (decrease) in cash and cash equivalents		(36,973)	9,500
Effects of foreign exchange rate changes		160	(222)
Cash and cash equivalents at the beginning of the year		152,481	143,203
Cash and cash equivalents at year-end		115,668	152,481

Reconciliation of cash and cash equivalents			
Cash on hand	23	3,814	4,403
Cash balances with Central Bank	23	75,134	142,235
Bank accounts	24	46,269	21,122
Mandatory reserve, special restricted and pledged balances with Central Bank	23	(9,549)	(15,279)
Cash and cash equivalents at year-end		115,668	152,481

*For further breakdown see the following page.

The Group has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year.

The Group presents a statement of cash flows that includes an analysis of all cash flows in total, including both continuing and discontinued operations (see Note 5).

Interest received in 2020 amounted to ISK 49,410 million (2019: ISK 60,624 million) and interest paid in 2020 amounted to ISK 20,455 million (2019: ISK 22,736 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 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 15 Amounts are in ISK million

Consolidated Statement of Cash Flows

	2020	2019
Depreciation, amortisation and write-offs	1,765	1,960
Share of profit of associates	(45)	(64)
Accrued interest and fair value changes on debt issued and subordinated loans	12,621	11,450
Net impairment on financial assets	9,056	3,568
Foreign exchange gain	(387)	(143)
Net (gain) loss from sales of a subsidiary, property and equipment	(427)	17
Unrealised fair value loss recognised in profit or loss	1,545	192
Discontinued operations, net of income tax	524	125
Bank tax	1,588	3,528
Income tax	2,472	3,682
Other changes	68	9
Non-cash items included in profit for the year	28,780	24,324

Mandatory reserve, special restricted and pledged balances with Central Bank	5,730	1,833
Loans to credit institutions	(7,725)	(15,268)
Bonds and debt instruments	(73,163)	17,254
Loans to customers	(100,076)	(52,638)
Shares and equity instruments	(885)	(3,953)
Other assets	(995)	1,644
Non-current assets and liabilities held for sale	1,168	3
Deposits from Central Bank and credit institutions	7,714	15,232
Deposits from customers	51,984	37,678
Derivative instruments and short positions	8,942	(2,944)
Other liabilities	(2,229)	(6,839)
Changes in operating assets and liabilities	(109,535)	(7,998)

Non-cash transactions 2020

During the year Íslandsbanki sold its 63.5% stake in Borgun hf. (see Note 5). ISK 415 million of the sale price is due in 2021. Prior to the sale, shares in BVS ehf. a company holding series C preferred shares in Visa Inc., which were not part of the sale of Borgun hf., were transferred to the old owners of Borgun hf.

During the year the Bank sold an office building for the price of ISK 100 million with ISK 85 million outstanding at the end of the year.

Non-cash transactions 2019

During the year the Bank repurchased own debt securities amounting to ISK 4,319 million by issuing new debt.

The Group recognised right-of-use assets amounting to ISK 4,505 million and the same amount in lease liabilities following the adoption of IFRS 16 - Leases.

The notes on pages 17 to 88 are an integral part of these Consolidated Financial Statements.

Íslandsbanki hf. Consolidated Financial Statements 2020 16 Amounts are in ISK million

Notes to the Consolidated Financial Statements

1. Corporate information

Íslandsbanki hf., the parent company, was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The consolidated financial statements for the year ended 31 December 2020 ("the consolidated financial statements") comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

At the end of 2020 the Bank was wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Group provides a wide range of financial services such as retail banking, corporate banking, investment banking, wealth management and asset financing. The Group operates mainly in the Icelandic market.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 10 February 2021.

2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The consolidated financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At year-end 2020 the exchange rate of the ISK against the USD was 127.21 and 156.10 for the EUR (year-end 2019: USD 121.10 and EUR 135.83).

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, the consolidated financial statements have been prepared on a going concern basis.

Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, short positions in listed bonds, derivative financial instruments, and certain bonds issued by the Group.

Recognised financial liabilities designated as hedged items in qualifying fair value hedge relationships are measured at amortised cost adjusted for changes in fair value attributable to the risk being hedged.

Non-current assets and disposal groups held for sale are measured at the lower of its carrying amount and fair value less costs to sell.

3. Significant accounting estimates and judgements

The preparation of the 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. Key sources of estimation uncertainty include the allowance for credit losses, the determination of fair value of financial instruments and intangible assets. Actual results may differ from those estimates.

Estimates and underlying assumptions are under constant review. Changes in accounting estimates are recognised when they occur.

The COVID-19 pandemic continues to evolve and the economic environment in which the Group operates could continue to negatively impact the Group's financial results. The current environment, particularly, requires judgements and estimates in certain areas. The Group closely monitors the changing conditions and their impact.

Impairment of financial assets

The main assumptions used for calculating the allowance for credit losses that are subject to significant judgement include the following:

• Probability of default (PD), loss given default (LGD) and exposure at default (EAD)

• Macroeconomic variables for multiple scenarios build on available information

• Assessment of significant increase in credit risk

3. Cont'd

The probability of default (PD), exposure at default (EAD), and loss given default (LGD) inputs used to estimate expected credit losses are modelled based on variables that are most closely related with credit losses in the relevant portfolio. This includes macroeconomic variables, demographic variables, variables related to past payment history among other variables. These variables are sourced both internally and externally. Significant judgements required for measuring expected credit loss (ECL) include the following:

- Determining criteria for assessing what constitutes a significant increase in credit risk
- Establishing the forward-looking scenarios and their relative weightings
- Choosing appropriate models and assumptions for the measurement of ECL

The Group has made temporary changes to the impairment model due to the COVID-19 pandemic.The Group's impairment process allows for temporary changes to the impairment model to account for circumstances when it becomes evident that existing or expected risk factors have not been appropriately considered in the credit risk rating or modelling process. The COVID-19 pandemic has created such circumstances for the tourism industry and therefore an adjustment is warranted.To account for the material uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they have been further classified into four impact groups as described in Note 51. Where the increase was found to be significant (groups 2-4), the exposure was transferred to Stage 2. In addition, an overlay factor was applied to the expected credit loss, comparable to an increase in up to three risk classes, and a higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios. The common risk factor in tourism was found to apply to loans to customers with a net carrying amount of ISK 94,202 million and the cumulative effect of the stage transfer and credit loss overlay amounted to ISK 6,115 million (see Note 15).

The All Risk Committee determined that it was appropriate to adjust the weights of the scenarios due to the COVID-19 pandemic, generally the scenarios are weighted 25%-50%-25% (good, base, bad) but it was determined appropriate to set the weights at 15%-55%-30%, as this would best represent the probability-weighted average over all possible scenarios. When deciding on the appropriate weights for the three scenarios, management used sensitivity analysis that indicated that a shift of 5% weight from the baseline to the pessimistic scenario would increase the impairment allowance by ISK 500 million while a 5% shift from the baseline to the optimistic scenario would in decrease the allowance by ISK 250 million.

Substantial uncertainty remains with regards to the impact of the COVID-19 pandemic on the credit quality of the Group’s credit exposures in future periods and therefore the assessment of expected credit losses.

The allowance for credit losses is further discussed in Notes 26-27, in Notes 47-55 on risk management and in Note 67.4.

Fair value of financial instruments

The fair value of financial instruments where an active market or quoted prices are not available are decided upon by using estimation procedures. Financial instruments measured at fair value are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. Level 3 financial assets are measured at fair value using valuation techniques based on significant unobservable inputs. The valuation of Level 3 financial assets is a subjective area as the assumption on which the valuation is based on is not easily observable and subject to management's assessment. Any changes made to the evaluation criteria could have a significant impact on the Group's results and financial position. The valuation methods are discussed in Notes 20-21 and in Note 67.4.

Intangible assets

Intangible assets are amortised over four to ten years. Intangible assets are reviewed at each reporting date to determine whether there is any indication of impairment. The value in use method is used by the Group to determine the recoverable amount of intangible assets. The following relevant criteria are considered when assessing whether indications of impairment exists:

- A decline in the asset's market value
- Plans to restructure or liquidate the asset
- The asset generates less income than anticipated

Intangible assets are further discussed in Note 30 and in Note 67.9.

4. Changes to accounting policies

The Group adopted amendments to IAS 39 – Financial Instruments: Recognition and Measurement, and IFRS 7 – Financial Instruments: Disclosures (together referred to as "Interest Rate Benchmark Reform – Phase 1"), as of 1 January 2020. The amendments modified certain hedge accounting requirements, relating to the method that is used to assess the effectiveness of the hedging relationship, to provide relief from potential effect of uncertainty caused by the Interest Rate Benchmark Reform, prior to the transition to alternative benchmark interest rates. The amendments did not have a significant impact on the Group's consolidated financial statements.

To manage the transition to alternative benchmark interest rates the Bank has set up a working group responsible for the overall transition. A comprehensive review of legacy contracts has been carried out by the Bank's legal department and new contract language has been introduced to accommodate the benchmark reform. The work on systems and processes, along with education and communication to major stakeholders, is ongoing. It is expected that financial effects of the transition will be minimal to the Group. The Bank is continually monitoring developments in the benchmark reform work in jurisdictions affected and will adjust its implementation accordingly, should the need arise.

A number of other amendments to IFRS standards became effective from 1 January 2020 but they did not have a material impact on the Group's consolidated financial statements.

Changes to IFRS standards issued but not effective at the reporting date

A new IFRS standard and amendments to several IFRS standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Changes that are likely to affect the Group's future financial reporting are described below but no significant impact is currently expected.

Interest Rate Benchmark Reform - Phase 2

The Group adopted amendments to IFRS 9 – Financial Instruments, IAS 39 – Financial Instruments: Recognition and Measurement, IFRS 7 – Financial Instruments: Disclosures, and IFRS 16 – Leases (together referred to as "Interest Rate Benchmark Reform – Phase 2"), as of 1 January 2021. The amendments provide practical relief from certain requirements in the standards relating to the replacement of benchmark interest rates in contracts with new alternative benchmark interest rates. When the basis for determining the contractual cash flows of financial instruments is changed as a direct consequence of the Interest Rate Benchmark Reform and the change is made on an economically equivalent basis, the amendments provide a practical expedient to update the effective interest rate of the financial instruments rather than to recognise an immediate gain or loss in the income statement. The amendments also provide a series of reliefs from certain hedge accounting requirements when a change required by the Interest Rate Benchmark Reform occurs to a hedged item and/or hedging instrument. If qualifying criteria are met, hedging relationships that are directly impacted by the Interest Rate Benchmark Reform will be able to continue hedge accounting upon transition to alternative benchmark interest rates. The amendments will not have a significant impact on the Group's consolidated financial statements.

Notes to the Consolidated Financial Statements

5. Investments in subsidiaries

		31.12.2020	31.12.2019
Íslandssjóðir hf., an investment fund management company, Hagasmári 3, 201 Kópavogur	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%
Borgun hf., a payment acquirer and issuing processor, Ármúli 30, 108 Reykjavík	Iceland	-	63.5%

In addition Íslandsbanki has control over ten other non-significant subsidiaries.

Borgun hf.

A formal sale process of Borgun hf. began early in 2019, as was announced by Íslandsbanki on 11 January 2019. The sale was an open and transparent process led by Swiss based investment banking firm Corestar Partners and Íslandsbanki's Corporate Finance department.

On 11 March 2020 Íslandsbanki signed an agreement to sell its 63.5% stake in Borgun hf. to Salt Pay Co Ltd. but this transaction was subject to Financial Supervisory Authority of the Central Bank ("FSA") approval of the purchaser's acquisition of a qualifying holding. On 7 July 2020 the Bank concluded the sale. The net loss of Borgun hf. during the period, 1 January until the selling date 7 July 2020, amounting to ISK 828 million and net profit from the sale amounting to ISK 427 million is included in the line item "Discontinued operations, net of income tax" in the Consolidated Income Statement.

Before the sale, in the first quarter of 2020, Borgun hf. was classified as disposal group held for sale, in accordance with IFRS 5 - Non-current assets and disposal groups held for sale, resulting in a change in the presentation. As a result the comparative figures in the Consolidated Income Statement for the year 2019 have been restated and Borgun hf. is no longer presented separately in the Operating segments note.

Restated Consolidated Income Statement 2019	Published accounts	Reclassified Borgun hf.	Restated accounts
Interest income	62,846	(881)	61,965
Interest expense	(29,170)	27	(29,143)
Net interest income	33,676	(854)	32,822
Fee and commission income	21,026	(8,974)	12,052
Fee and commission expense	(7,667)	6,514	(1,153)
Net fee and commission income	13,359	(2,460)	10,899
Net financial income	(817)	(3)	(820)
Net foreign exchange loss	143	(4)	139
Other operating income	2,134	(9)	2,125
Other net operating income	1,460	(16)	1,444
Total operating income	48,495	(3,330)	45,165
Salaries and related expenses	(16,279)	2,260	(14,019)
Other operating expenses	(11,828)	1,359	(10,469)
Contribution to the Depositors' and Investors' Guarantee Fund	(936)	-	(936)
Bank tax	(3,528)	-	(3,528)
Total operating expenses	(32,571)	3,619	(28,952)
Profit before net impairment on financial assets	15,924	289	16,213
Net impairment on financial assets	(3,663)	183	(3,480)
Profit before tax	12,261	472	12,733
Income tax expense	(3,682)	(227)	(3,909)
Profit for the year from continuing operations	8,579	245	8,824
Discontinued operations, net of income tax	(125)	(245)	(370)
Profit for the year	8,454	-	8,454

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Notes to the Consolidated Financial Statements

5. Cont'd

The following tables summarise key information relevant to Borgun hf. The amounts shown are before inter-company eliminations.

Interim Income Statement of Borgun hf.	2020 1.1-7.7	2019 1.1-7.7
Net interest income	312	444
Net fee and commission income	800	768
Other operating income	(46)	39
Total operating income	1,066	1,251
Salaries and related expenses	(1,141)	(1,210)
Other operating expenses	(679)	(720)
Net impairment on financial assets	(84)	(39)
Loss before tax	(838)	(718)
Income tax expense	10	143
Loss for the period	(828)	(575)
Amounts included in other comprehensive income for the period		
Changes in fair value of financial assets, net of tax	(913)	893
Total comprehensive income (expense) for the period	(1,741)	318

Interim Statement of Financial Position of Borgun hf.	7.7.2020
Loans to credit institutions	7,123
Bonds and debt instruments	499
Derivatives	69
Loans to customers	4,309
Shares and equity instruments	3,559
Property and equipment	1,293
Intangible assets	445
Other assets	4,531
Total assets	21,828
Debt issued and other borrowed funds	266
Tax liabilities	21
Other liabilities	15,301
Total liabilities	15,588
Net assets of Borgun hf.	6,240

	2020 1.1-7.7	2019 1.1-7.7
Net cash used in operating activities	(512)	(2,952)
Net cash (used in) provided by investing activities	(923)	137
Net cash provided (used in) by financing activities	577	(403)
Net decrease in cash and cash equivalents	(858)	(3,218)

Íslandsbanki hf. Consolidated Financial Statements 2020 22 Amounts are in ISK million

6. Operating segments

Segment information is presented in accordance with the Group's management and internal reporting structure. The segments' operating result are reported to the Board of Directors and the Chief Executive Officer, who are responsible for allocating resources to the reportable segments and assessing their financial performance.

An operating segment is a distinguishable component of the Group, for which discrete financial information is available, that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segment is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market.

The Bank has three main business segments: Personal Banking, Business Banking and Corporate & Investment Banking. Operating segments pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium. Capital allocation to the business units is based on the pillar 1 regulatory capital requirement, the pillar 2-R capital requirement calculated according to the Bank's ICAAP and the combined buffer requirement as stipulated in the act on financial undertakings. Income tax and bank tax with breakdown for each segment is according to the current tax rates.

The Group comprises the following operating segments:

Personal Banking

Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. Íslandsbanki's customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services and contact the contact centre.

Business Banking

Business Banking provides small and medium-sized enterprises (SMEs) with comprehensive financial services and Ergo, the Bank's asset financing service, is also part of the division. Business Banking serves customers in business centres and branches close to their business. Via online banking and app, customers have full overview of their business and day-to-day operations are easy to manage.

Corporate & Investment Banking

Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors and affluent individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage and private banking services. The division is sector-focused, building and maintaining relationships with key customer segments within Iceland. Outside of Iceland, Íslandsbanki has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury and Proprietary Trading

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business units sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres

Cost centres comprise the CEO's office (Human Resources, Marketing & Communications, Strategy, and Legal), Finance excluding Treasury and Proprietary Trading, IT, Risk Management and Compliance. Group Internal Audit is included in cost centres, however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank's Board of Directors.

Subsidiaries, eliminations and adjustments

Subsidiaries include Íslandssjóðir hf., Allianz Ísland hf. and other less significant subsidiaries (see Note 5).

Before its sale on 7 July 2020, the subsidiary Borgun hf. was classified as non-current assets and disposal groups held for sale, accordingly the comparative figures in this disclosure have been restated.

Assets and liabilities of subsidiaries, that are classified as non-current assets and disposal groups held for sale, are included in the column "Other subsidiaries" and all inter-company eliminations for those subsidiaries are included in the column "Eliminations & adjustments".

Following is an overview showing the Group's performance with a breakdown by operating segments.

6. Cont'd

2020	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	10,749	10,536	8,530	3,734	(215)	33,334	37	33,371
Net fee and commission income	3,049	1,917	4,075	(317)	7	8,731	1,794	10,525
Other net operating income	305	50	922	(1,420)	287	144	(887)	(743)
Total operating income	14,103	12,503	13,527	1,997	79	42,209	944	43,153
Salaries and related expenses	(2,416)	(1,940)	(1,583)	(280)	(5,926)	(12,145)	(772)	(12,917)
Other operating expenses	(2,584)	(1,164)	(870)	(263)	(4,488)	(9,369)	(460)	(9,829)
Contribution to the Depositors' and Investors' Guarantee Fund	(482)	(161)	(35)	(1)	-	(679)	-	(679)
Bank tax	(613)	(340)	(514)	(105)	(16)	(1,588)	-	(1,588)
Net impairment on financial assets	(517)	(5,485)	(2,805)	(8)	-	(8,815)	(1)	(8,816)
Cost allocation	(4,690)	(2,967)	(3,020)	323	10,354	-	-	-
Profit (loss) before tax	2,801	446	4,700	1,663	3	9,613	(289)	9,324
Income tax expense	(887)	(204)	(1,356)	112	(5)	(2,340)	(132)	(2,472)
Profit (loss) for the year from continuing operations	1,914	242	3,344	1,775	(2)	7,273	(421)	6,852
Net segment revenue from external customers	20,911	14,750	19,922	(13,597)	223	42,209	944	43,153
Net segment revenue from other segments	(6,808)	(2,247)	(6,395)	15,594	(144)	-	-	-
Fee and commission income	4,797	1,948	4,152	(9)	7	10,895	1,756	12,651
Depreciation, amortisation and write-offs	(300)	(163)	(18)	-	(1,178)	(1,659)	(7)	(1,666)
At 31 December 2020								
Loans to customers	419,882	232,580	353,953	302	-	1,006,717	-	1,006,717
Other assets	3,212	2,199	795	320,578	10,893	337,677	(203)	337,474
Total segment assets	423,094	234,779	354,748	320,880	10,893	1,344,394	(203)	1,344,191
Deposits from customers	324,815	189,847	137,791	31,674	-	684,127	(4,672)	679,455
Other liabilities	1,327	1,481	4,908	463,943	5,915	477,574	958	478,532
Total segment liabilities	326,142	191,328	142,699	495,617	5,915	1,161,701	(3,714)	1,157,987
Allocated equity	34,850	37,804	63,432	45,708	899	182,693	3,511	186,204
Risk exposure amount	229,610	235,371	392,804	60,037	5,960	923,782	9,739	933,521

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

Amounts are in ISK million

6. Cont'd

2019	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	10,578	10,812	8,397	3,169	(251)	32,705	117	32,822
Net fee and commission income	4,504	1,716	3,530	(236)	7	9,521	1,378	10,899
Other net operating income	77	25	564	(848)	2,197	2,015	(571)	1,444
Total operating income	15,159	12,553	12,491	2,085	1,953	44,241	924	45,165
Salaries and related expenses	(2,791)	(1,993)	(1,720)	(253)	(6,516)	(13,273)	(746)	(14,019)
Other operating expenses	(2,131)	(1,184)	(660)	(257)	(5,725)	(9,957)	(512)	(10,469)
Contribution to the Depositors' and Investors' Guarantee Fund	(530)	(314)	(89)	(3)	-	(936)	-	(936)
Bank tax	(483)	(339)	(486)	(2,205)	(15)	(3,528)	-	(3,528)
Net impairment on financial assets	(547)	(1,098)	(1,043)	(791)	-	(3,479)	(1)	(3,480)
Cost allocation	(5,606)	(3,381)	(3,421)	278	12,130	-	-	-
Profit (loss) before tax	3,071	4,244	5,072	(1,146)	1,827	13,068	(335)	12,733
Income tax expense	(924)	(1,192)	(1,445)	318	(478)	(3,721)	(188)	(3,909)
Profit (loss) for the year from continuing operations	2,147	3,052	3,627	(828)	1,349	9,347	(523)	8,824
Net segment revenue from external customers	18,137	14,492	19,191	(9,708)	2,129	44,241	924	45,165
Net segment revenue from other segments	(2,978)	(1,939)	(6,700)	11,793	(176)	-	-	-
Fee and commission income	6,224	1,724	3,574	124	8	11,654	398	12,052
Depreciation, amortisation and write-offs	(215)	(112)	(21)	-	(1,367)	(1,715)	(10)	(1,725)
At 31 December 2019								
Loans to customers	329,265	230,842	334,788	2	-	894,897	4,735	899,632
Other assets	3,553	3,085	347	267,384	10,648	285,017	14,841	299,858
Total segment assets	332,818	233,927	335,135	267,386	10,648	1,179,914	19,576	1,199,490
Deposits from customers	290,894	167,623	113,455	49,517	-	621,489	(3,176)	618,313
Other liabilities	1,497	1,822	2,553	374,459	6,209	386,540	14,575	401,115
Total segment liabilities	292,391	169,445	116,008	423,976	6,209	1,008,029	11,399	1,019,428
Allocated equity	29,981	38,924	58,953	42,882	1,145	171,885	8,177	180,062
Risk exposure amount	194,601	247,565	367,456	48,063	6,968	864,653	19,897	884,550

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6. Cont'd

Subsidiaries, eliminations & adjustments

2020	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments*	Total
Net interest income	11	12	22	(8)	37
Net fee and commission income	1,185	724	(30)	(85)	1,794
Other net operating income	172	10	9	(1,078)	(887)
Total operating income	1,368	746	1	(1,171)	944
Salaries and related expenses	(584)	(188)	-	-	(772)
Other operating expenses	(183)	(420)	(1)	144	(460)
Net impairment on financial assets	-	-	-	(1)	(1)
Profit (loss) before tax	601	138	-	(1,028)	(289)
Income tax expense	(119)	(11)	-	(2)	(132)
Profit (loss) for the year from cont. operations	482	127	-	(1,030)	(421)
Net segment revenue from external customers	1,651	646	-	(1,353)	944
Net segment revenue from other segments	(283)	100	1	182	-
Fee and commission income	1,664	725	-	(633)	1,756
Depreciation, amortisation and write-offs	-	8	-	(15)	(7)
At 31 December 2020					
Total assets	2,249	1,425	9,080	(12,957)	(203)
Total liabilities	271	600	36	(4,621)	(3,714)
Total equity	1,978	825	9,044	(8,336)	3,511

*Included are all eliminations on consolidation and the impact of the sale of Borgun hf.

2019	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	28	26	36	27	117
Net fee and commission income	1,089	1,069	(30)	(750)	1,378
Other net operating income	156	(1)	(5)	(721)	(571)
Total operating income	1,273	1,094	1	(1,444)	924
Salaries and related expenses	(558)	(188)	-	-	(746)
Other operating expenses	(181)	(471)	(2)	142	(512)
Net impairment on financial assets	-	-	-	(1)	(1)
Profit (loss) before tax	534	435	(1)	(1,303)	(335)
Income tax expense	(107)	(87)	-	6	(188)
Profit (loss) for the year from cont. operations	427	348	(1)	(1,297)	(523)
Net segment revenue from external customers	1,475	1,080	(16)	(1,615)	924
Net segment revenue from other segments	(202)	14	17	171	-
Fee and commission income	1,520	1,069	-	(2,191)	398
Depreciation, amortisation and write-offs	-	(3)	-	(7)	(10)
At 31 December 2019					
Total assets	2,726	1,201	28,829	(13,180)	19,576
Total liabilities	302	412	15,755	(5,070)	11,399
Total equity	2,424	789	13,074	(8,110)	8,177

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7. Quarterly statements (unaudited)

2020	Q4	Q3	Q2	Q1	Total
Net interest income	8,258	8,305	8,228	8,580	33,371
Net fee and commission income	2,865	2,862	2,307	2,491	10,525
Net financial income (expense)	783	(255)	(181)	(1,738)	(1,391)
Net foreign exchange gain	87	101	208	55	451
Other operating income	63	44	71	19	197
Salaries and related expenses	(3,381)	(2,842)	(3,447)	(3,247)	(12,917)
Other operating expenses	(2,692)	(2,268)	(2,424)	(2,445)	(9,829)
Contribution to the Depositors' and Investors' Guarantee Fund	(154)	(50)	(247)	(228)	(679)
Bank tax	(414)	(416)	(399)	(359)	(1,588)
Net impairment on financial assets	(1,829)	(1,058)	(2,439)	(3,490)	(8,816)
Profit (loss) before tax	3,586	4,423	1,677	(362)	9,324
Income tax expense	(234)	(1,350)	(119)	(769)	(2,472)
Profit (loss) for the period from continuing operations	3,352	3,073	1,558	(1,131)	6,852
Discontinued operations, net of income tax	173	288	(313)	(245)	(97)
Profit (loss) for the period	3,525	3,361	1,245	(1,376)	6,755

8. Net interest income

	2020	2019
Cash and balances with Central Bank	1,750	4,452
Loans at amortised cost	51,628	54,837
Financial assets mandatorily at fair value through profit or loss	2,314	2,630
Other assets	3	46
Total interest income	55,695	61,965
Deposits from Central Bank and credit institutions	(736)	(625)
Deposits from customers	(7,700)	(15,242)
Debt issued and other borrowed funds at fair value through profit or loss	(608)	(734)
Debt issued and other borrowed funds at amortised cost	(11,179)	(9,818)
Subordinated loans	(763)	(501)
Other interest expense*	(1,338)	(2,223)
Total interest expense	(22,324)	(29,143)
Net interest income	33,371	32,822

*Thereof is lease liabilities' interest expense amounting to ISK 87 million (2019: ISK 70 million).
Net interest margin on total assets 2.6% (2019: 2.7%).

9. Net fee and commission income

	2020	2019
Asset management	2,382	2,225
Investment banking and brokerage	2,487	2,430
Payment processing	4,378	3,810
Loans and guarantees	2,014	1,510
Other fee and commission income	1,390	2,077
Total fee and commission income	12,651	12,052

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9. Cont'd

	2020	2019
Brokerage	(360)	(337)
Clearing and settlement	(1,766)	(806)
Other fee and commission expense	-	(10)
Total fee and commission expense	(2,126)	(1,153)
Net fee and commission income	10,525	10,899

Fee and commission income by segment is disclosed in Note 6.

10. Net financial expense

	2020	2019
Net loss on financial assets and financial liabilities mandatorily at FVTPL	(1,321)	(422)
Net loss on financial liabilities designated as at FVTPL	(72)	(399)
Net gain on fair value hedges	2	1
Net financial expense	(1,391)	(820)
Shares and related derivatives	165	(575)
Dividend income	18	32
Bonds and related derivatives	(1,586)	144
Other derivatives	82	(23)
Net loss on financial assets and financial liabilities mandatorily at FVTPL	(1,321)	(422)
Debt issued and other borrowed funds designated as at FVTPL	(72)	(399)
Net loss on financial liabilities designated as at FVTPL	(72)	(399)
Clean fair value gain on interest rate swaps designated as hedging instruments	54	285
Fair value loss on bonds issued by the Group attributable to interest rate risk	(52)	(284)
Net gain on fair value hedges	2	1

11. Net foreign exchange gain

	2020	2019
Cash and balances with Central Bank	160	(222)
Financial assets mandatorily at fair value through profit or loss	13,652	(1,781)
Loans at amortised cost	22,673	5,686
Other assets	10	-
Net foreign exchange gain for assets	36,495	3,683
Deposits	(10,279)	(1,749)
Debt issued and other borrowed funds designated as at FVTPL	(6,468)	(1,667)
Debt issued and other borrowed funds at amortised cost	(14,802)	(362)
Subordinated loans	(4,495)	234
Net foreign exchange loss for liabilities	(36,044)	(3,544)
Net foreign exchange gain	451	139

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Notes to the Consolidated Financial Statements

12. Other operating income

	2020	2019
Share of profit of associates, net of income tax	44	63
Legal dispute settlement	-	1,103
Legal fees	90	93
Rental income	39	38
Depositor's and Investor's Guarantee Fund reversed contribution	-	847
Other net operating income (expense)	24	(19)
Other operating income	197	2,125

13. Personnel and salaries

	2020	2019
Salaries	9,940	10,801
Contributions to pension funds	1,505	1,618
Social security charges and financial activities tax*	1,391	1,493
Other salary-related expenses	81	107
Salaries and related expenses	12,917	14,019

*Financial activities tax calculated on salaries is 5.5% (2019: 5.5%).

	2020		2019	
	The Bank	The Group	The Bank	The Group
Average number of employees	774	910	842	1,079
Positions at year-end	745	779	749	984

Total amount of compensation to the Board of Directors, the CEO and Executive Board are specified as follows:

	2020	2019
Hallgrímur Snorrason, Chairman of the Board	10.5	7.6
Heiðrún Jónsdóttir, Vice-Chairman of the Board	8.9	7.9
Anna Þórðardóttir, member of the Board	7.9	7.9
Árni Stefánsson, member of the Board	7.9	7.8
Frosti Ólafsson, member of the Board	5.9	-
Guðrún Þorgeirsdóttir, member of the Board	5.9	-
Herdís Gunnarsdóttir, member of the Board	0.4	-
Friðrik Sophusson, former Chairman of the Board	2.5	11.3
Tómas Már Sigurðsson, former Vice-Chairman of the Board	2.0	6.6
Auður Finnbogadóttir, former member of the Board	1.7	7.6
Flóki Halldórsson, former member of the Board	4.7	-
Helga Valfells, former Vice-Chairman of the Board	-	2.3
Alternate board members	-	1.3
Total salaries	58.3	60.3

Contribution to pension funds for the Board of Directors amounted to ISK 8.8 million (2019: ISK 7.1 million).

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13. Cont'd

	2020		2019	
	Total salaries	Contri-butions to pension funds	Total salaries	Contri-butions to pension funds
Birna Einarsdóttir, CEO	48.7	11.6	50.9	11.9
Ásmundur Tryggvason, Managing Director of Corporate & Investment Banking	43.3	6.1	39.5	5.6
Guðmundur Kristinn Birgisson, Chief Risk Officer	36.5	5.2	36.1	5.1
Jón Guðni Ómarsson, Chief Financial Officer	42.0	5.9	41.5	6.1
Riaan Dreyer, Director of Information Technology	37.7	5.6	13.6	2.0
Sigríður Hrefna Hrafnkelsdóttir, Managing Director of Personal Banking	37.7	5.3	37.8	5.3
Una Steinsdóttir, Managing Director of Business Banking*	50.8	7.4	42.6	6.1
Sigríður Olgeirsdóttir, former Director of Information Technology	-	-	22.8	3.3
Vilhelm Þorsteinsson, former Managing Director of Corporate & Investment Banking	-	-	3.3	0.5
Total	296.7	47.1	288.1	45.9

*The salary increase is due to an employment anniversary payment for 30 years of service. The payment is in accordance with the collective agreement of the Confederation of Icelandic Bank and Finance Employees (SSF).

The amounts in the table above comprise salaries for the managing directors for their executive board responsibilities. Included in total salaries are non-monetary benefits such as the use of cars owned by the Group.

As of 1 January 2017, the Bank has not had an active remuneration policy in place as stated in the Bank's compensation policy. Included in total salaries are paid performance-based salaries, which were earned in 2016, and paid by the Bank in 2020. For the Bank's CEO those amounted to ISK 3.9 million (2019: ISK 4.1 million) and for the managing directors the payments amounted to ISK 8.8 million (2019: ISK 10.7 million). There were no unpaid performance-based salaries at year-end 2020.

There were no share based payments in the years 2020 and 2019.

14. Other operating expenses

	2020	2019
Professional services	1,539	1,778
Software and IT expenses	4,581	4,616
Real estate and office equipment	627	593
Depreciation, amortisation and write-offs	1,666	1,725
Other administrative expenses	1,416	1,757
Other operating expenses	9,829	10,469
Auditors' fees		
Audit of the financial statements	92	99
Review of interim financial statements	18	16
Other services	6	5
Auditors' fees	116	120

15. Net impairment on financial assets

	2020	2019
Expected credit loss, on-balance sheet items*	(8,450)	(3,341)
Expected credit loss, off-balance sheet items	(366)	(52)
Changes in provision due to court rulings	-	(87)
Net impairment on financial assets	(8,816)	(3,480)

*The main reasons for the additional expected credit loss allowance are: an increase related to the COVID-19 pandemic (ISK 6,115 million), increased expected credit loss for a few customers (ISK 1,185 million), and due to a less favourable economic environment (ISK 583 million). For further information see Note 3.

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16. Income tax expense

Recognised income tax is based on applicable tax laws. The income tax rate for legal entities in 2020 is 20% (2019: 20%). Special financial activities tax is calculated as 6% of taxable profit exceeding ISK 1 billion in accordance with the Act on Financial Activities Tax no. 165/2011. The special financial activities tax is calculated on the Bank's profit. The effective income tax rate in the Group's income statement for the year 2020 is 26.5% (2019: 30.7%).

	2020	2019
Current tax expense excluding discontinued operations	3,052	2,610
Special financial activities tax	801	642
Difference in prior year's calculated income tax	68	(1)
Changes in deferred tax assets and deferred tax liabilities	(1,449)	658
Income tax recognised in the income statement	2,472	3,909
Income tax recognised in other comprehensive income	(16)	(233)

	2020		2019	
Profit before tax	9,324		12,733	
20% income tax calculated on the profit for the year	1,865	20.0%	2,547	20.0%
Special financial activities tax	801	8.6%	642	5.0%
Income not subject to tax	(566)	(6.1%)	(143)	(1.1%)
Non-deductible expenses	318	3.4%	708	5.6%
Other differences	54	0.6%	155	1.2%
Effective income tax expense	2,472	26.5%	3,909	30.7%

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

17. Discontinued operations, net of income tax

	2020	2019
Net profit (loss) from foreclosed assets	37	(178)
Net loss from disposal groups held for sale	(542)	(171)
Net profit from sale of a subsidiary	427	-
Income tax expense	(19)	(21)
Discontinued operations, net of income tax	(97)	(370)

18. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2020	2019	2020	2019
Profit attributable to shareholders of the Bank	7,158	9,179	7,061	8,809
Weighted average number of outstanding shares	10,000	10,000	10,000	10,000
Basic earnings per share	0.72	0.92	0.71	0.88

The Group's basic and diluted earnings per share are equal as the Group has not issued any options, warrants, convertibles, or other financial instruments that dilute earnings per share (2019: none).

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19. Classification of financial assets and financial liabilities

At 31 December 2020	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	78,948	78,948
Loans to credit institutions	-	-	-	89,920	89,920
Listed bonds and debt instruments	90,603	-	-	-	90,603
Listed bonds and debt instruments used for economic hedging	37,468	-	-	-	37,468
Unlisted bonds and debt instruments	145	-	-	-	145
Derivatives	5,639	1,008	-	-	6,647
Loans to customers	-	-	-	1,006,717	1,006,717
Listed shares and equity instruments	2,933	-	-	-	2,933
Listed shares and equity instruments used for economic hedging	9,109	-	-	-	9,109
Unlisted shares and equity instruments	2,809	-	-	-	2,809
Other financial assets	-	-	-	3,692	3,692
Total financial assets	148,706	1,008	-	1,179,277	1,328,991
Deposits from Central Bank and credit institutions	-	-	-	39,758	39,758
Deposits from customers	-	-	-	679,455	679,455
Derivative instruments and short positions	6,936	-	-	-	6,936
Debt issued and other borrowed funds	-	48,032	94,438	244,804	387,274
Subordinated loans	-	-	-	27,194	27,194
Other financial liabilities	-	-	-	9,721	9,721
Total financial liabilities	6,936	48,032	94,438	1,000,932	1,150,338

At 31 December 2019	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Fair value through OCI	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	-	146,638	146,638
Loans to credit institutions	-	-	-	-	54,376	54,376
Listed bonds and debt instruments	33,302	-	-	-	-	33,302
Listed bonds and debt instruments used for economic hedging	18,220	-	-	-	-	18,220
Unlisted bonds and debt instruments	1,348	-	-	-	-	1,348
Derivatives	4,700	921	-	-	-	5,621
Loans to customers	-	-	-	-	899,632	899,632
Listed shares and equity instruments	3,779	-	-	-	-	3,779
Listed shares and equity instruments used for economic hedging	8,681	-	-	-	-	8,681
Unlisted shares and equity instruments	2,851	-	-	3,115	-	5,966
Other financial assets	-	-	-	-	5,757	5,757
Total financial assets	72,881	921	-	3,115	1,106,403	1,183,320
Deposits from Central Bank and credit institutions	-	-	-	-	30,925	30,925
Deposits from customers	-	-	-	-	618,313	618,313
Derivative instruments and short positions	6,219	-	-	-	-	6,219
Debt issued and other borrowed funds	-	41,816	49,352	-	215,213	306,381
Subordinated loans	-	-	-	-	22,674	22,674
Other financial liabilities	-	-	-	-	24,772	24,772
Total financial liabilities	6,219	41,816	49,352	-	911,897	1,009,284

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Notes to the Consolidated Financial Statements

20. Fair value information for financial instruments

Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell 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 Group 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.

The table below shows financial instruments carried at fair value at 31 December 2020 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Valuation techniques based on observable inputs other than the quoted prices included in Level 1, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Valuation techniques based on significant unobservable inputs, e.g. internal assumptions.

At 31 December 2020	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	128,071	-	145	128,216
Derivatives	-	6,647	-	6,647
Shares and equity instruments	11,931	30	2,890	14,851
Non-current assets and disposal groups held for sale	-	-	1,266	1,266
Total financial assets	140,002	6,677	4,301	150,980
Short positions	737	-	-	737
Derivative instruments	-	6,199	-	6,199
Debt issued and other borrowed funds designated as at FVTPL	94,438	-	-	94,438
Total financial liabilities	95,175	6,199	-	101,374

At 31 December 2019	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	51,522	-	1,348	52,870
Derivatives	-	5,621	-	5,621
Shares and equity instruments	12,383	27	6,016	18,426
Total financial assets	63,905	5,648	7,364	76,917
Short positions	814	-	-	814
Derivative instruments	-	5,405	-	5,405
Debt issued and other borrowed funds designated as at FVTPL	49,352	-	-	49,352
Total financial liabilities	50,166	5,405	-	55,571

Changes in Level 3 assets measured at fair value	Bonds and debt instruments	Shares and equity instruments	Non-current assets
Fair value at 1 January 2020	1,348	6,016	-
Purchases	18	7	-
Sales	-	-	(2,028)
Net loss on financial instruments recognised in profit or loss	(1,256)	(2)	-
Net gain on financial instruments recognised in other comprehensive income	-	-	114
Transfer to "Non-current assets and disposal groups held for sale"	-	(3,180)	3,180
Other changes	35	49	-
Fair value at 31 December 2020	145	2,890	1,266

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	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2019	1,514	4,688
Purchases	7	338
Sales and instalments	(537)	(52)
Net gain (loss) on financial instruments recognised in profit or loss	306	(118)
Net gain on financial instruments recognised in other comprehensive income	-	1,272
Other changes	58	(112)
Fair value at 31 December 2019	1,348	6,016

At the end of each reporting period the Group determines whether transfers have occured between levels in the hierarchy, by reassessing categorisation based on the lowest level input that is significant to the fair value measurement as a whole. No transfers between levels took place during the year.

Valuation process

The responsibility for the valuation of the fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Valuation techniques

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

Level 1: Fair value established from quoted market prices.

Assets at this level are financial assets and financial liabilities containing actively traded bonds and equities that are listed either domestically or abroad.

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

Assets at this level are assets and liabilities containing domestic bonds, equities as well as derivatives. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates.

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

Assets at this level contain primarily unlisted and illiquid equities and bonds. Unlisted equities and bonds are initially recorded at their transaction price but are revalued each quarter based on the models as described above.

The economic crisis relating to the COVID-19 pandemic is the main reason for the decrease in Level 3 bonds and debt instruments during the year.

At 31 December 2020 the Group's Level 3 equities amounted to ISK 2,890 million:

-These include shares in seven professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,676 million. The Group receives information from fund managers which use valuation models for the valuation of these equities.

-Other Level 3 equities amounting to ISK 1,214 million.

-Series C preferred shares in Visa Inc., which the Group holds, were reclassified as held for sale during the year and transfered to "Non-current assets and disposal groups held for sale".

At 31 December 2020 the Group's Level 3 bonds amounted to ISK 145 million:

-The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on projected risk and financing cost.

At 31 December 2020 the Group's Level 3 shares classified as an asset held for sale in the consolidated financial statements amounted to ISK 1,266 million:

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The Group holds Series C preferred shares in Visa Inc. amounting to ISK 1,266 million, which are subject to selling restrictions for a period of up to eight years. Shares in this series will be converted into Series A shares listed on the New York Stock Exchange (NYSE), but the number of shares that the Group will receive in that series will be determined by the share price of the class as well as the amount of compensation that Visa Inc. may have to pay in connection with certain disputes brought before courts in several European countries. The fair value of the preferred shares is therefore determined by the market value of Visa Inc. in addition to an assessment of the present value of possible claims for damages. It is clear that important factors in the fair value calculation are based on a subjective assessment.

Sensitivity analysis for Level 3 assets

The valuations of Level 3 assets are in general uncertain and subject to various factors. The favourable and unfavourable scenarios can be considered as being likely movements in valuation within a year. The very favourable and very unfavourable scenarios are considered less likely, but not impossible and are not worst-case scenarios for some of the assets.

The table below shows how profit (loss) and total comprehensive income would have been affected if one or more of the inputs for fair value measurement in Level 3 were changed.

At 31 December 2020 **Effect on profit or (loss):**	Carrying amount	Very favourable	Favourable	Unfavourable	Very unfavour-able
Level 3 Bonds and debt instruments	145	1,015	773	(132)	(145)
Level 3 Shares and equity instruments	2,890	1,897	539	(571)	(878)
Effect on comprehensive income:					
Level 3 Non-current assets and disposal groups held for sale	1,266	1,898	949	(633)	(1,266)

At 31 December 2019 **Effect on profit or (loss):**	Carrying amount	Very favourable	Favourable	Unfavourable	Very unfavour-able
Level 3 Bonds and debt instruments	1,348	330	257	(296)	(1,348)
Level 3 Shares and equity instruments	2,901	2,399	645	(762)	(1,614)
Effect on comprehensive income:					
Level 3 Shares in Visa Inc.	3,115	1,246	623	(623)	(1,246)

21. Financial instruments not carried at fair value

Assets

The fair value of “Loans to customers” may differ from their net carrying amount because the interest rates they carry may not reflect the interest rates that similar new loans would carry. The fair value is estimated by subtracting from or adding to the net carrying amount of the loans the discounted interest rate difference calculated from the reporting date until the next interest reset or maturity, whichever comes first. Since the interest rate difference is estimated using internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is adequately approximated by the carrying amount as they are short-term in nature. They are thus classified as Level 2.

Liabilities

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. Most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. The fair value for longer term fixed rate deposits is calculated with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

Observed market value is used for the fair value of "Debt issued and other borrowed funds" where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin in the Group's issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions and payments due to leasing contracts and they are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

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The following table shows the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined in Note 20.

At 31 December 2020	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	78,948	-	78,948	78,948
Loans to credit institutions	-	89,920	-	89,920	89,920
Loans to customers	-	-	1,010,315	1,010,315	1,006,717
Other financial assets	-	3,692	-	3,692	3,692
Total financial assets	-	172,560	1,010,315	1,182,875	1,179,277
Deposits from Central Bank and credit institutions	-	39,827	-	39,827	39,758
Deposits from customers	-	679,607	-	679,607	679,455
Debt issued and other borrowed funds	194,849	112,165	-	307,014	292,836
Subordinated loans	-	26,003	-	26,003	27,194
Other financial liabilities	-	9,721	-	9,721	9,721
Total financial liabilities	194,849	867,323	-	1,062,172	1,048,964

At 31 December 2019	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	146,638	-	146,638	146,638
Loans to credit institutions	-	54,376	-	54,376	54,376
Loans to customers	-	-	902,053	902,053	899,632
Other financial assets	-	5,757	-	5,757	5,757
Total financial assets	-	206,771	902,053	1,108,824	1,106,403
Deposits from Central Bank and credit institutions	-	31,027	-	31,027	30,925
Deposits from customers	-	618,592	-	618,592	618,313
Debt issued and other borrowed funds	165,044	100,334	-	265,378	257,029
Subordinated loans	22,626	-	-	22,626	22,674
Other financial liabilities	-	24,772	-	24,772	24,772
Total financial liabilities	187,670	774,725	-	962,395	953,713

22. Offsetting financial assets and financial liabilities

The following tables show reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2020	Financial assets before netting	Netting with financial liabilities	Net financial assets	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 financial assets recognised in the balance sheet
Reverse repurchase agreements	898	-	898	-	-	-	898	-	898
Derivatives	6,647	-	6,647	(761)	(4,330)	(187)	1,369	-	6,647
Total assets	7,545	-	7,545	(761)	(4,330)	(187)	2,267	-	7,545

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At 31 December 2019	Financial assets subject to netting arrangements: Financial assets before netting	Netting with financial liabilities	Net financial assets	Amounts not set off but subject to master netting arrangements and similar agreements: 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 financial assets recognised in the balance sheet
Reverse repurchase agreements ..	1,114	-	1,114	-	-	-	1,114	-	1,114
Derivatives	5,621	-	5,621	(1,374)	(3,146)	(88)	1,013	-	5,621
Total assets	6,735	-	6,735	(1,374)	(3,146)	(88)	2,127	-	6,735

	Financial liabilities subject to netting arrangements: Financial liabilities before netting	Netting with financial assets	Net financial liabilities	Amounts not set off but subject to master netting arrangements and similar agreements: 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 financial liabilities recognised in the balance sheet
At 31 December 2020									
Derivative instruments and short positions	6,936	-	6,936	(761)	(504)	-	5,671	-	6,936
At 31 December 2019									
Derivative instruments and short positions	6,219	-	6,219	(1,374)	(1,139)	-	3,706	-	6,219

23. Cash and balances with Central Bank

	31.12.2020	31.12.2019
Cash on hand	3,814	4,403
Balances with Central Bank	65,585	125,842
Balances with Central Bank subject to special restrictions*	1,288	1,679
Included in cash and cash equivalents	70,687	131,924
Cash and balances pledged as collateral to the Central Bank	288	1,114
Mandatory reserve deposits with Central Bank	7,973	13,600
Cash and balances with Central Bank	78,948	146,638

*Balances as defined in Act no. 37/2016 on the treatment of króna-denominated assets subject to special restrictions and rules no. 490/2016 on special reserve requirements for new foreign currency inflows.

24. Loans to credit institutions

	31.12.2020	31.12.2019
Money market loans	43,646	33,254
Bank accounts	46,269	21,122
Other loans	5	-
Loans to credit institutions	89,920	54,376

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25. Derivative instruments and short positions

At 31 December 2020	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	1,888	181,914	3,581	62,275
Cross-currency interest rate swaps	2,861	63,067	45	3,171
Equity forwards	7	813	1,488	6,702
Foreign exchange forwards	70	4,010	362	8,582
Foreign exchange swaps	1,738	32,227	435	24,101
Foreign exchange options	-	-	1	25
Bond forwards	83	10,907	287	29,596
Derivatives	6,647	292,938	6,199	134,452
Short positions in listed bonds	-	-	737	550
Total	6,647	292,938	6,936	135,002

At 31 December 2019				
Interest rate swaps	1,254	114,393	3,575	96,212
Cross-currency interest rate swaps	3,015	91,950	880	13,073
Equity forwards	141	4,664	298	4,001
Foreign exchange forwards	212	5,460	321	10,217
Foreign exchange swaps	867	30,990	298	24,928
Bond forwards	132	12,756	33	6,219
Derivatives	5,621	260,213	5,405	154,650
Short positions in listed bonds	-	-	814	734
Total	5,621	260,213	6,219	155,384

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

Short positions are in Icelandic Government bonds and bonds issued by municipalities, banks and public companies. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and other issuers. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain EUR denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate EUR denominated bonds (see Note 36) arising from changes in EURIBOR benchmark interest rates. The Group applies fair value hedge accounting to the hedging relationships and for the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of IBOR reform. At 31 December 2020 the total fair value of the interest rate swaps was positive and amounted to ISK 1,008 million (2019: ISK 921 million) and their total notional amount was ISK 46,830 million (2019: ISK 40,749).

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26. Loans to customers

At 31 December 2020	Gross carrying amount Stage 1	Stage 2	Stage 3	Expected credit loss Stage 1	Stage 2	Stage 3	Net carrying amount
Individuals	423,570	9,011	7,561	(1,608)	(254)	(903)	437,377
Commerce and services	60,062	64,350	5,958	(511)	(3,151)	(2,448)	124,260
Construction	36,551	5,420	997	(283)	(195)	(138)	42,352
Energy	7,997	701	-	(17)	(8)	-	8,673
Financial services	1,539	-	-	-	-	-	1,539
Industrial and transportation	46,526	30,971	3,989	(243)	(783)	(1,899)	78,561
Investment companies	15,287	5,504	3,628	(268)	(427)	(284)	23,440
Public sector and non-profit organisations	10,869	58	1	(17)	-	-	10,911
Real estate	112,189	42,169	6,794	(461)	(1,655)	(1,534)	157,502
Seafood	120,845	1,365	319	(237)	(9)	(181)	122,102
Loans to customers	835,435	159,549	29,247	(3,645)	(6,482)	(7,387)	1,006,717

At 31 December 2019	Gross carrying amount Stage 1	Stage 2	Stage 3	Expected credit loss Stage 1	Stage 2	Stage 3	Net carrying amount
Individuals	338,335	4,119	9,362	(1,319)	(168)	(1,148)	349,181
Commerce and services	115,679	6,999	6,515	(739)	(194)	(1,772)	126,488
Construction	39,248	849	4,924	(310)	(53)	(238)	44,420
Energy	7,913	-	-	(26)	-	-	7,887
Financial services	2,315	-	-	-	-	-	2,315
Industrial and transportation	77,492	3,338	3,503	(278)	(221)	(1,546)	82,288
Investment companies	19,542	4,369	265	(260)	(216)	(110)	23,590
Public sector and non-profit organisations	12,279	44	15	(23)	(2)	(1)	12,312
Real estate	140,604	3,831	2,345	(542)	(89)	(590)	145,559
Seafood	105,411	249	385	(148)	(10)	(295)	105,592
Loans to customers	858,818	23,798	27,314	(3,645)	(953)	(5,700)	899,632

27. Expected credit loss

Total allowances for expected credit losses

	Stage 1	Stage 2	Stage 3	Total
Cash and balances with Central Bank	2	-	-	2
Loans to credit institutions	109	-	-	109
Loans to customers	3,645	6,482	7,387	17,514
Other financial assets	15	4	-	19
Off-balance sheet loan commitments and financial guarantees	347	483	225	1,055
At 31 December 2020	4,118	6,969	7,612	18,699
Cash and balances with Central Bank	4	-	-	4
Loans to credit institutions	67	-	-	67
Loans to customers	3,645	953	5,700	10,298
Other financial assets	9	3	86	98
Off-balance sheet loan commitments and financial guarantees	403	55	231	689
At 31 December 2019	4,128	1,011	6,017	11,156

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27. Cont'd

The following tables reconcile the opening and closing balances for accumulated expected credit losses for loans to customers, and off-balance sheet loan commitments and financial guarantees.

Loans to customers

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2020	3,645	953	5,700	10,298
Transfer to Stage 1	3,577	(2,827)	(750)	-
Transfer to Stage 2	(1,743)	3,200	(1,457)	-
Transfer to Stage 3	(171)	(1,314)	1,485	-
Transfer to "Non-current assets and disposal groups held for sale"	(50)	(12)	(83)	(145)
Net remeasurement of loss allowance	(3,316)	6,024	1,201	3,909
New financial assets originated or purchased	2,104	597	2,516	5,217
Derecognitions and maturities	(401)	(139)	(404)	(944)
Write-offs	-	-	(1,498)	(1,498)
Recoveries of amounts previously written off	-	-	159	159
Foreign exchange	-	-	37	37
Unwinding of interest	-	-	481	481
At 31 December 2020	3,645	6,482	7,387	17,514
At 1 January 2019	3,277	1,079	3,689	8,045
Transfer to Stage 1	1,725	(1,343)	(382)	-
Transfer to Stage 2	(1,336)	1,687	(351)	-
Transfer to Stage 3	(178)	(720)	898	-
Net remeasurement of loss allowance	(1,216)	145	2,727	1,656
New financial assets originated or purchased	1,803	278	353	2,434
Derecognitions and maturities	(430)	(169)	(188)	(787)
Write-offs	-	(4)	(1,616)	(1,620)
Recoveries of amounts previously written off	-	-	249	249
Foreign exchange	-	-	10	10
Unwinding of interest	-	-	311	311
At 31 December 2019	3,645	953	5,700	10,298

Off-balance sheet loan commitments and financial guarantees

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2020	403	55	231	689
Transfer to Stage 1	230	(146)	(84)	-
Transfer to Stage 2	(74)	252	(178)	-
Transfer to Stage 3	(11)	(53)	64	-
Net remeasurement of loss allowance	(466)	269	103	(94)
New loan commitments and financial guarantees	376	166	128	670
Derecognitions and maturities	(111)	(60)	(39)	(210)
At 31 December 2020	347	483	225	1,055
At 1 January 2019	410	142	84	636
Transfer to Stage 1	152	(81)	(71)	-
Transfer to Stage 2	(20)	39	(19)	-
Transfer to Stage 3	(9)	(18)	27	-
Net remeasurement of loss allowance	(455)	(27)	131	(351)
New loan commitments and financial guarantees	447	20	119	586
Derecognitions and maturities	(122)	(20)	(40)	(182)
At 31 December 2019	403	55	231	689

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Notes to the Consolidated Financial Statements

28. Investments in associates

		31.12.2020	31.12.2019
Auðkenni hf., an information security company, Borgartún 31, 105 Reykjavík	Iceland	23.8%	23.8%
JCC ehf., a cash centre service company, Sundaborg 15, 108 Reykjavík	Iceland	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company, Katrínartún 2, 105 Reykjavík	Iceland	30.1%	30.8%

	2020	2019
Investments in associates at the beginning of the year	746	682
Share of gain of associates	44	64
Transfer to "Non-current assets and disposal groups held for sale"	(15)	-
Investments in associates	775	746

Summarised financial information in respect of the Group's associates is set out below:

	2020	2019
Revenue	6,388	6,259
Profit	296	281
Assets	5,651	5,445
Liabilities	(2,808)	(2,832)
Net assets	2,843	2,613
Group's share of net assets of associates	775	746

29. Property and equipment

At 31 December 2020	Land and buildings	Right-of-use assets: Buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	4,096	4,634	4,068	12,798
Additions during the year	35	-	441	476
Disposals and write-offs during the year	(120)	(69)	(583)	(772)
Remeasurement	-	184	-	184
Transfer to "Non-current assets and disposal groups held for sale"	(953)	(20)	(807)	(1,780)
Historical cost	3,058	4,729	3,119	10,906
Balance at the beginning of the year	(1,447)	(420)	(1,763)	(3,630)
Depreciation during the year	(19)	(421)	(398)	(838)
Disposals and write-offs during the year	17	(67)	455	405
Transfer to "Non-current assets and disposal groups held for sale"	109	2	387	498
Accumulated depreciation	(1,340)	(906)	(1,319)	(3,565)
Carrying amount	1,718	3,823	1,800	7,341
Annual depreciation rates	0-2%	8-31%	8-33%	

Official real estate value of land and buildings	1,497
Insurance value of buildings	2,369
Insurance value of fixtures, equipment and vehicles	1,991

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29. Cont'd

At 31 December 2019	Land and buildings	Right-of-use assets: Land, buildings & vehicles	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	4,054	-	3,984	8,038
Impact of adopting IFRS 16	-	4,505	-	4,505
Additions during the year	56	3	271	330
Disposals and write-offs during the year	(14)	-	(187)	(201)
Remeasurement	-	126	-	126
Historical cost	4,096	4,634	4,068	12,798
Balance at the beginning of the year	(1,402)	-	(1,365)	(2,767)
Depreciation during the year	(47)	(420)	(574)	(1,041)
Disposals and write-offs during the year	2	-	176	178
Accumulated depreciation	(1,447)	(420)	(1,763)	(3,630)
Carrying amount	2,649	4,214	2,305	9,168
Annual depreciation rates	0-2%	3-33%	8-35%	
Official real estate value of land and buildings				2,240
Insurance value of buildings				3,545
Insurance value of fixtures, equipment and vehicles				2,020

30. Intangible assets

At 31 December 2020	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,782	3,383	318	5,483
Additions during the year and internal development	257	-	-	257
Write-offs during the year	(139)	-	-	(139)
Transfer to "Non-current assets and disposal groups held for sale"	(277)	-	(318)	(595)
Historical cost	1,623	3,383	-	5,006
Balance at the beginning of the year	(528)	(625)	-	(1,153)
Amortisation during the year	(346)	(267)	-	(613)
Write-offs during the year	110	-	-	110
Transfer to "Non-current assets and disposal groups held for sale"	128	-	-	128
Accumulated amortisation	(636)	(892)	-	(1,528)
Carrying amount	987	2,491	-	3,478
Amortisation rates	10-25%	10%	-	

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30. Cont'd

At 31 December 2019	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,639	3,644	248	5,531
Additions during the year and internal development	169	7	70	246
Write-offs during the year	(26)	(268)	-	(294)
Historical cost	1,782	3,383	318	5,483
Balance at the beginning of the year	(222)	(307)	-	(529)
Amortisation during the year	(313)	(318)	-	(631)
Write-offs during the year	7	-	-	7
Accumulated amortisation	(528)	(625)	-	(1,153)
Carrying amount	1,254	2,758	318	4,330
Amortisation rates	10-25%	10-25%	-	

31. Other assets

	31.12.2020	31.12.2019
Receivables	1,767	4,810
Unsettled securities transactions	1,550	279
Accruals	200	253
Prepaid expenses	181	468
Deferred tax assets	259	476
Other assets	168	322
Other assets	4,125	6,608

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

	31.12.2020	31.12.2019
Repossessed collateral:		
Land and buildings	1,548	739
Industrial equipment and vehicles	7	44
Assets of disposal groups classified as held for sale	1,618	292
Non-current assets and disposal groups held for sale	3,173	1,075

At year-end 2020 the Group classified the assets and liabilities of BVS ehf. (63.5%) and Miðengi ehf. (100%) as assets and liabilities of disposal groups held for sale.

Assets and liabilities of disposal groups classified as held for sale:

	31.12.2020	31.12.2019
Shares	1,266	1
Receivables	224	90
Land and buildings	100	165
Other assets	28	36
Total assets	1,618	292
Other liabilities	27	-
Total liabilities	27	-

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33. Deposits from Central Bank and credit institutions

	31.12.2020	31.12.2019
Deposits from credit institutions	39,650	30,808
Repurchase agreements with Central Bank	108	117
Deposits from Central Bank and credit institutions	39,758	30,925

34. Deposits from customers

	31.12.2020	31.12.2019
Demand deposits and deposits with maturity up to 3 months	582,746	530,960
Term deposits with maturity of more than 3 months	96,709	87,353
Deposits from customers	679,455	618,313

Deposits from customers specified by owners	31.12.2020		31.12.2019	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	8,145	1%	12,553	2%
Municipalities	7,561	1%	5,619	1%
Companies	326,799	48%	299,204	48%
Individuals	336,950	50%	300,937	49%
Deposits from customers	679,455	100%	618,313	100%

35. Pledged assets

	31.12.2020	31.12.2019
Financial assets pledged as collateral against liabilities	236,901	201,249
Financial assets pledged as collateral with the Central Bank	5,088	5,914
Financial assets pledged as collateral in foreign banks	167	402
Pledged assets against liabilities	242,156	207,565

The Group has pledged assets against the issuance of covered bonds under Icelandic law, which are pledged on a pool of consumer mortgage loans.

The Group has also pledged assets with the Central Bank to ensure the clearing of the Icelandic payment system as well as other contracts with the Central Bank.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

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36. Debt issued and other borrowed funds

	Issued	Maturity		Interest	31.12.2020	31.12.2019
Covered bonds in ISK	2019-2020	2021	At maturity	Fixed rates	5,076	3,918
Covered bonds in ISK	2015-2020	2023	At maturity	Fixed rates	29,496	20,170
Covered bonds in ISK	2020	2027	Amortising	Fixed rates	5,386	-
Covered bonds in ISK - CPI-linked	2014-2015	2020	At maturity	Fixed rates	-	4,359
Covered bonds in ISK - CPI-linked	2015-2017	2022	At maturity	Fixed rates	19,228	18,512
Covered bonds in ISK - CPI-linked	2012-2018	2024	At maturity	Fixed rates	36,797	35,752
Covered bonds in ISK - CPI-linked	2015-2018	2026	At maturity	Fixed rates	28,571	27,661
Covered bonds in ISK - CPI-linked	2019-2020	2028	Amortising	Fixed rates	25,606	14,228
Covered bonds in ISK - CPI-linked	2017-2018	2030	At maturity	Fixed rates	26,285	25,463
Covered bonds					176,445	150,063
Senior unsecured bonds in EUR**	2016	2020	At maturity	Fixed rates	-	7,782
Senior unsecured bonds in SEK*	2019	2020	At maturity	Floating rates	-	4,557
Senior unsecured bonds in SEK	2018	2021	At maturity	Fixed rates	1,553	1,308
Senior unsecured bonds in SEK*	2018-2019	2021	At maturity	Floating rates	21,462	18,913
Senior unsecured bonds in EUR	2019	2021	At maturity	Floating rates	1,795	1,559
Senior unsecured bonds in SEK	2018	2022	At maturity	Floating rates	15,574	12,990
Senior unsecured bonds in EUR**	2019	2022	At maturity	Fixed rates	47,494	41,570
Senior unsecured bonds in NOK	2019	2022	At maturity	Floating rates	14,982	13,856
Senior unsecured bonds in EUR***	2018	2024	At maturity	Fixed rates	48,032	41,816
Senior unsecured bonds in NOK	2019	2024	At maturity	Fixed rates	6,187	5,709
Senior unsecured bonds in ISK	2019	2024	Monthly	Floating rates	2,664	3,553
Senior unsecured bonds in EUR**	2020	2023	At maturity	Fixed rates	46,944	-
Senior unsecured bonds in ISK	2020	2025	At maturity	Fixed rates	2,709	-
Bonds issued					209,396	153,613
Bills issued					1,433	2,705
Debt issued and other borrowed funds					387,274	306,381

*The Bank repurchased own bonds during the year amounting to ISK 6,084 million.

**These bond issuances are classified as being designated as at fair value through profit or loss. At 31 December 2020 the total carrying amount of the bonds amounted to ISK 94,438 million and included in the amount are fair value changes amounting to ISK 729 million. The carrying amount of the bonds at 31 December 2020 was ISK 16 million higher than the contractual amount due at maturity.

***The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments (see Note 25). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in EURIBOR benchmark interest rates. The Group applies fair value hedge accounting to the hedging relationships and for the purpose of evaluating whether the hedging relationship is expected to be highly effective, the Group assumes that the benchmark interest rate is not altered as a result of IBOR reform. At 31 December 2020 the total carrying amount of the bond issuance amounted to ISK 48,032 million and included in the amount are fair value changes amounting to ISK 824 million.

The Bank has issued additional covered bonds for its own use, for example for the purpose of securities lending with regards to market making agreements. These covered bond amounts are not included in the total.

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37. Subordinated loans

	Issued	Maturity		Interest	31.12.2020	31.12.2019
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	At maturity	Floating, STIBOR + 2.0%	11,646	9,714
Subordinated loans in SEK	2018	2028	At maturity	Floating, STIBOR + 2.5%	7,775	6,485
Subordinated loans in SEK	2019	2029	At maturity	Floating, STIBOR + 3.9%	7,773	6,475
Subordinated loans					27,194	22,674

38. Changes in liabilities arising from financing activities

			Non-cash changes			
	1.1.2020	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.12.2020
Covered bonds in ISK	24,088	14,400	1,470	-	-	39,958
Covered bonds in ISK - CPI-linked	125,975	2,532	7,980	-	-	136,487
Senior unsecured bonds in ISK	3,553	1,728	92	-	-	5,373
Senior unsecured bonds FX	58,892	(7,093)	1,013	8,741	-	61,553
Senior unsecured bonds FX at fair value	49,352	38,069	608	6,468	(59)	94,438
Senior unsecured bonds used for hedging	41,816	(463)	566	6,061	52	48,032
Other borrowed funds	2,705	(1,330)	58	-	-	1,433
Subordinated loans	22,674	(738)	763	4,495	-	27,194
Total	329,055	47,105	12,550	25,765	(7)	414,468

			Non-cash changes			
	1.1.2019	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.12.2019
Covered bonds in ISK	20,756	2,060	1,272	-	-	24,088
Covered bonds in ISK - CPI-linked	118,057	1,263	6,655	-	-	125,975
Senior unsecured bonds in ISK	-	3,528	25	-	-	3,553
Senior unsecured bonds FX	46,162	12,139	1,016	(425)	-	58,892
Senior unsecured bonds FX at fair value	68,154	(22,509)	734	1,667	1,306	49,352
Senior unsecured bonds used for hedging	40,714	(465)	497	786	284	41,816
Other borrowed funds	7,133	(4,809)	358	23	-	2,705
Subordinated loans	16,216	6,190	501	(233)	-	22,674
Total	317,192	(2,603)	11,058	1,818	1,590	329,055

39. Tax assets and tax liabilities

	31.12.2020		31.12.2019	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	5,448	-	6,670
Deferred tax	259	2	476	1,183
Tax in the balance sheet	259	5,450	476	7,853

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39. Cont'd

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2019	215	678
Calculated income tax for 2019	256	3,223
Income tax payable in 2020	-	(2,535)
Income tax recognised in other comprehensive income	9	(183)
Prior year's income tax adjustment	(4)	-
Deferred tax assets and tax liabilities 31.12.2019	476	1,183
Calculated income tax for 2020	229	1,902
Income tax payable in 2021	-	(3,109)
- thereof income tax recognised in other comprehensive income	-	12
Changes in deferred tax assets and deferred tax liabilities due to equity	-	26
Transfer to "Non-current assets and disposal groups held for sale"	(446)	-
Deferred tax assets and tax liabilities 31.12.2020	259	2

2020	Net balance at 1 January	Transfer to non-current assets	Recognised in profit or (loss)	Recognised in equity	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(1,097)	32	87	-	(978)	-	(978)
Intangible assets	(511)	-	21	-	(490)	-	(490)
Assets and liabilities in foreign currency	(276)	-	(144)	-	(420)	-	(420)
Deferred foreign exchange difference	(426)	(9)	1,540	-	1,105	1,105	-
Derivatives	(42)	22	(70)	-	(90)	-	(90)
Lease liabilities	851	-	(54)	-	797	797	-
Debt issued and other borrowed funds	268	4	6	(38)	240	240	-
Other items	30	-	63	-	93	93	-
Tax loss carry forwards	496	(496)	-	-	-	-	-
	(707)	(447)	1,449	(38)	257	2,235	(1,978)
Set-off of deferred tax assets together with liabilities of the same taxable entities						(1,976)	1,976
Tax assets (liabilities)	(707)	(447)	1,449	(38)	257	259	(2)

2019	Net balance at 1 January	Recognised in profit or (loss)	Recognised in equity	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(249)	(848)	-	(1,097)	-	(1,097)
Intangible assets	(527)	16	-	(511)	-	(511)
Assets and liabilities in foreign currency	(264)	(12)	-	(276)	-	(276)
Deferred foreign exchange difference	(213)	(213)	-	(426)	-	(426)
Derivatives	194	(236)	-	(42)	-	(42)
Lease liabilities	-	851	-	851	851	-
Debt issued and other borrowed funds	329	(253)	192	268	268	-
Other items	(2)	32	-	30	30	-
Tax loss carry forwards	269	227	-	496	496	-
	(463)	(436)	192	(707)	1,645	(2,352)
Set-off of deferred tax assets together with liabilities of the same taxable entities					(1,169)	1,169
Tax assets (liabilities)	(463)	(436)	192	(707)	476	(1,183)

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40. Other liabilities

	31.12.2020	31.12.2019
Accruals	2,311	3,217
Liabilities to retailers for credit cards	-	14,765
Lease liabilities	3,962	4,256
Provision for effects of court rulings	288	75
Expected credit loss for off-balance sheet loan commitments and financial guarantees	1,055	689
Withholding tax	915	1,559
Unsettled securities transactions	1,379	515
Deferred income	-	229
Sundry liabilities	1,983	1,758
Non-current liabilities and disposal groups held for sale	27	-
Other liabilities	11,920	27,063

41. Custody assets

	31.12.2020	31.12.2019
Custody assets - not managed by the Group	2,863,328	2,496,313

42. Leases

The Group as a lessee

The Group's significant leases are leases for offices, branches, and storage. Most leases are CPI-linked real estate leases with duration of 5-10 years with extension options. Lease commitments are recognised on-balance sheet except for short-term leases and leases of low-value assets. During the year 2020 the total expense for leases of low-value assets and short-term leases amounted to ISK 23 million (2019: ISK 21 million). During the year 2020 the total cash outflow for leases amounted to ISK 500 million (2019: ISK 493 million).

Right-of-use assets are presented in the line item “Property and equipment” (see Note 29). Lease liabilities are presented in the line item “Other liabilities” (see Note 40). Interest expense from lease liabilities is presented in the line item "Interest expense" (see Note 8).

The Group as a lessor

Net investment in finance lease receivables

	31.12.2020	31.12.2019
Due within 1 year	14,030	17,559
Due in 1-5 years	31,152	30,960
Due in more than 5 years	3,132	3,538
Total gross investment in the lease	48,314	52,057
Due within 1 year	12,263	15,303
Due in 1-5 years	28,380	27,628
Due in more than 5 years	2,716	2,692
Total present value of lease payments*	43,359	45,623
Unearned interest income	4,955	6,434

*The Group presents finance lease receivables in the line item “Loans to customers”.

Expected credit loss allowance	990	202
Interest income from finance lease receivables during the year	2,439	3,165

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43. Related party

Íslandsbanki is wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments (ISFI). As a result, the Icelandic Government and the Icelandic State Financial Investments are defined as related parties. The Group has applied the partial exemption for government-related entities, as described in IAS 24, and does not disclose those transactions in the related party Note.

The Board of Directors and key management personnel of the Bank, ISFI and subsidiaries of the Bank, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner the Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third party counterparties.

Cash and balances with the Central Bank are disclosed under Note 23 and Deposits from the Central Bank are disclosed under Note 33.

All loans to employees are provided on general business terms of the Group and the balances do not reflect collaterals held by the Group.

At 31 December 2020	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Shareholders with control over the Group	-	-	-	3
Board of Directors, key management personnel and other related parties	440	393	47	45
Associated companies	31	342	(311)	228
Balances with related parties	471	735	(264)	276

2020	Interest income	Interest expense	Other income	Other expense
Board of Directors, key management personnel and other related parties	16	9	4	-
Associated companies	-	7	-	1,627
Transactions with related parties	16	16	4	1,627

At 31 December 2019	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Board of Directors, key management personnel and other related parties	324	392	(68)	51
Associated companies	16	830	(814)	213
Balances with related parties	340	1,222	(882)	264

2019	Interest income	Interest expense	Other income	Other expense
Board of Directors, key management personnel and other related parties	25	7	1	-
Associated companies	7	17	3	1,620
Transactions with related parties	32	24	4	1,620

At year-end 2020 there were no expected credit loss balances outstanding with related parties (2019: ISK 2 million). No share option programmes were operated during the year. For related party remuneration see Note 13.

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44. Contingencies

Contingent liabilities

Borgun hf. – Landsbanki case

Borgun hf., a former subsidiary of Íslandsbanki, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun hf. in late 2014. Landsbankinn claims that Borgun's management did not disclose all available information that might have affected the value of Borgun hf. during the sales process, namely the value of its stake in Visa Europe which was sold to Visa International shortly after the Borgun hf. sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit against Borgun hf. and others on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. Landsbankinn does not quantify the claim, but its estimate of the lost profit from having sold its shares in Borgun hf. is approximately ISK 1,930 million. Court appointed assessors presented their assessment in November 2019. A reassessment has been demanded and senior assessors have been appointed by the court. It is uncertain when a ruling is to be expected. In 2020, the Group closed an agreement on the sale of all its stake in Borgun hf. In that agreement Íslandsbanki undertook to reimburse 63.47% of losses incurred by Borgun hf. or the buyer as a result of an unfavourable outcome in the Landsbanki case. The Group has not recognised a provision as a result of this event.

45. Events after the reporting period

No events have arisen after the reporting period that require amendments or additional disclosures in the consolidated financial statements for the year ended 31 December 2020.

46. Risk management

Risk governance

The Group is exposed to various risk factors and managing these risks is an integral part of its operations. The Bank emphasises sound governance principles. The risk management and internal control framework of the Group is based on a three lines of defence model, as referred to in the European Banking Authority Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Group's internal rules.

The first line of defence consists of the Bank's business and support units; the second line of defence comprises the Bank's internal control units, Risk management and Compliance; and the third line of defence is Internal Audit which gives the Board an independent assessment of the quality of corporate governance, risk management and internal controls.

The Group's management body has a dual structure. The Board of Directors of the Bank has a supervising role in setting and monitoring the execution of set policies, the sound control of accounting and financial management and ensuring that group Internal audit, Compliance and Risk management are effective. The Chief Executive Officer (CEO), the Chief Risk Officer (CRO), other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at the Group lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through risk management policies and the Risk Appetite Statement. To assist the Board in fulfilling its oversight responsibilities, the Board has appointed three board subcommittees.

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Group's operations are consistent with applicable legislation and the Group's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer, the Compliance Officer as well as other members of the Executive Board. The CEO also engages the members of the senior management committees.

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The CRO heads the Risk management function and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at the Group and for verifying that the Bank has the right resources and an appropriate organisation to manage its risks efficiently.

The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the Group and cannot be removed without the Board's prior approval.

The CRO is independent from the business units, is a member of the Executive Board and reports directly to the CEO. The CRO provides an independent view on the Group's exposure to risk. The CRO has the right but not the responsibility to veto certain risk-taking decisions of the senior management committees if an internal control unit considers the proposal inconsistent with the Bank's risk appetite, policies or procedures.

Risk management is mandated to identify, understand, measure and monitor the risks that the Group is exposed to. It provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by the management and business or support units as to whether they are consistent with the risk appetite and risk polices set by the Board.

Where necessary, Risk management makes recommendations to senior management and the Board to improve or clarify risk policies, procedures and limits.

Risk Management provides a holistic view on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

Business and support units are, however, responsible for maintaining their independent view on the risks inherent in their operations and reporting to senior management any foreseeable breaches from limits, policies or strategic direction.

Risk management provides the senior management and the Board with all relevant risk related information to enable it to define the Bank's risk appetite.

The General Counsel is appointed by and reports directly to the CEO. The General Counsel provides legal advice to the Bank's senior management, including the Board of Directors, and manages the Bank's legal department which provides comprehensive legal advice to the Bank's business segments and support units.

The Chief Audit Executive (CAE) is appointed by the Board, reports directly to Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Group, including internal audit tasks which have been outsourced.

The Compliance Officer heads the compliance function and is responsible for defining the daily tasks of the department and assessing the adequacy of its professional skills. The Compliance Officer is responsible for monitoring the compliance risk management framework for the Bank and maintaining oversight for compliance risk throughout the Bank.

The Bank's Compliance Officer is selected and engaged by the CEO, subject to Board confirmation. The Compliance Officer cannot be removed without the Board's prior approval. The Financial Supervisory Authority of the Central Bank and Chief Audit Executive shall be notified of the dismissal or departure of the Compliance Officer.

The Compliance Officer reports directly to the Board on the overall compliance risk profile of the Bank.

Each employee is responsible for understanding the risk related to their day-to-day work, for knowing and understanding the respective internal and external rules and procedures, for using the alert procedures in the event of possible fraudulent activities and for conducting business in accordance with the Bank's code of conduct.

The Bank's senior management committee structure is twofold. Firstly the two executive committees, the Executive Board and the All Risk Committee, that are responsible for the implementation of the Board approved business strategy, risk appetite and policies. Secondly the four business committees, the Asset and Liability Committee (ALCO), the Senior Credit Committee (SCC), the Investment Committee (IC) and the Operational and Security Committee (OSC), which are responsible for the approval of business or operational proposals subject to internal rules and guidelines issued by the executive committees and the Board.

The members of the senior management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter issued by the CEO.

More information about the Group's risk management and risk assessment processes is available in the unaudited Pillar 3 2020 Report, which is available on the Bank's website: www.islandsbanki.is.

47. Credit risk

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 financial contract with the Group.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. industrial sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes 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 loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as financial guarantees, loan commitments and derivatives.

The Group has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Group's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Group measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

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48. Maximum credit exposure

The Group'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. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions that have been made because of these items. The maximum credit exposure for a derivative contract is calculated by adding potential future credit exposure to the positive market value of the contract.

The industry breakdown shows the 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 Government guarantee schemes issued in response to the COVID-19 pandemic are presented in the line item “Loans to customers”. Of these, ISK 2,236 million are subject to 100% Government guarantee, ISK 1,034 million to 85% Government guarantee and ISK 400 million to 70% Government guarantee.

As a part of the agreement on the sale of Borgun hf. the Group took on certain guarantees with regards to chargeback risk that Borgun hf. is exposed to through its operations, which at year-end 2020 amount to about ISK 370 million. These guarantees are not included in the table below.

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

At 31 December 2020	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	78,948	-	-	-	-	-	-	-	-	-	78,948
Loans to credit institutions	-	-	-	-	-	89,920	-	-	-	-	-	89,920
Bonds and debt instruments	-	107,502	22	-	1,257	18,192	116	7	191	929	-	128,216
Derivatives	-	165	66	-	-	8,436	239	669	-	65	273	9,913
Loans to customers:	437,377	-	124,260	42,352	8,673	1,539	78,561	23,440	10,911	157,502	122,102	1,006,717
Overdrafts	10,506	-	12,117	3,104	10	1,097	5,915	954	949	2,422	5,138	42,212
Credit cards	14,942	-	1,170	247	6	14	318	23	77	62	29	16,888
Mortgages	377,155	-	-	-	-	-	-	-	-	-	-	377,155
Capital leases	5,612	-	26,236	2,742	16	-	7,328	153	38	1,058	176	43,359
Government guarantee schemes	15	-	2,968	57	-	-	323	9	-	136	86	3,594
Other loans	29,147	-	81,769	36,202	8,641	428	64,677	22,301	9,847	153,824	116,673	523,509
Other financial assets	437	645	110	10	6	2,285	29	39	88	35	8	3,692
Off-balance sheet items:	33,695	-	29,294	13,373	316	7,376	26,056	1,531	5,348	21,209	14,190	152,388
Financial guarantees	489	-	5,349	6,786	-	90	2,077	30	6	8,090	272	23,189
Undrawn loan commitments	-	-	5,445	3,111	-	-	17,896	846	-	10,145	2,583	40,026
Undrawn overdrafts	9,722	-	13,826	2,679	286	7,051	4,901	446	4,026	2,664	11,145	56,746
Credit card commitments	23,484	-	4,674	797	30	235	1,182	209	1,316	310	190	32,427
Maximum credit exposure	471,509	187,260	153,752	55,735	10,252	127,748	105,001	25,686	16,538	179,740	136,573	1,469,794

Amounts are in ISK million

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At 31 December 2019	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	146,638	-	-	-	-	-	-	-	-	-	146,638
Loans to credit institutions	-	-	-	-	-	54,376	-	-	-	-	-	54,376
Bonds and debt instruments	-	33,007	-	-	125	16,131	1,296	52	1,027	1,232	-	52,870
Derivatives	-	-	706	-	1,836	5,788	189	530	-	208	228	9,485
Loans to customers:	349,181	-	126,488	44,420	7,887	2,315	82,288	23,590	12,312	145,559	105,592	899,632
Overdrafts	12,333	-	14,506	3,425	110	2,289	4,927	654	1,204	3,220	6,270	48,938
Credit cards	16,466	-	1,579	271	5	24	437	40	106	63	35	19,026
Mortgages	281,450	-	5	-	-	-	-	-	-	44	-	281,499
Capital leases	5,774	-	28,422	2,700	15	-	7,322	139	39	1,005	207	45,623
Other loans	33,158	-	81,976	38,024	7,757	2	69,602	22,757	10,963	141,227	99,080	504,546
Other financial assets	532	-	199	7	6	4,803	117	41	10	36	6	5,757
Off-balance sheet items:	33,964	-	24,605	16,035	2,974	6,579	18,865	548	3,461	19,036	9,738	135,805
Financial guarantees	1,477	-	6,035	4,914	-	1,172	2,907	95	5	2,004	252	18,861
Undrawn loan commitments	-	-	1,871	8,297	2,442	-	9,726	-	-	11,303	1,804	35,443
Undrawn overdrafts	9,842	-	12,476	2,063	503	5,291	5,135	314	2,733	5,456	7,525	51,338
Credit card commitments	22,645	-	4,223	761	29	116	1,097	139	723	273	157	30,163
Maximum credit exposure	383,677	179,645	151,998	60,462	12,828	89,992	102,755	24,761	16,810	166,071	115,564	1,304,563

49. 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 Group takes a charge over assets such as real estate, vessels, cash and securities 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 Group 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. Exception from this are Government guarantees issued in response to the COVID-19 pandemic which are shown under other collateral. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

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Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Group'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 the gross carrying amount of loans and nominal off-balance sheet items, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their gross carrying amount, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. The maximum credit risk exposure is measured on net carrying value basis, and therefore collateral allocation can in some instances be higher. For capital leases the Group remains the owner of the leased object. In total ISK 38,872 million of the collateral are leased objects.

The following tables show the maximum exposure to credit risk by class of financial asset and collateral held against those exposures. An overview of collateral held by the Group against credit exposure is shown below for exposures in Stages 1 and 2 (non credit-impaired) and exposures in Stage 3 (credit-impaired):

At 31 December 2020 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Total credit exposure not covered by collateral	Associated ECL
Derivatives	9,913	-	-	5,318	-	-	5,318	4,595	-
Loans and commitments to customers:	1,136,660	706,096	95,947	11,869	49,504	102,673	966,089	170,571	10,957
Individuals	464,333	382,505	7	376	14,327	151	397,366	66,967	1,939
Commerce and services	149,751	61,610	157	659	25,444	32,211	120,081	29,670	4,029
Construction	54,812	41,329	11	1,297	2,108	2,249	46,994	7,818	570
Energy	8,989	6,545	-	1	14	14	6,574	2,415	25
Financial services	8,915	1,083	-	26	-	3,543	4,652	4,263	2
Industrial and transportation	102,499	39,750	12	178	7,088	29,500	76,528	25,971	1,127
Investment companies	21,626	6,903	-	1,891	79	11,125	19,998	1,628	709
Public sector and non-profit organisations	16,258	1,007	-	5	28	-	1,040	15,218	20
Real estate	173,328	149,991	-	7,424	343	1,157	158,915	14,413	2,280
Seafood	136,149	15,373	95,760	12	73	22,723	133,941	2,208	256
Total	1,146,573	706,096	95,947	17,187	49,504	102,673	971,407	175,166	10,957
Collateral held against credit-impaired exposures									
Loans and commitments to customers:	22,445	14,644	1,556	2,704	725	917	20,546	1,899	7,612
Individuals	6,739	5,973	21	3	144	4	6,145	594	935
Commerce and services	3,803	1,706	691	3	232	780	3,412	391	2,573
Construction	913	630	-	-	87	50	767	146	151
Industrial and transportation	2,118	431	810	51	246	71	1,609	509	1,922
Investment companies	3,345	714	-	2,611	6	-	3,331	14	284
Public sector and non-profit organisations	1	1	-	-	-	-	1	-	-
Real estate	5,383	5,082	5	36	7	12	5,142	241	1,565
Seafood	143	107	29	-	3	-	139	4	182
Total	22,445	14,644	1,556	2,704	725	917	20,546	1,899	7,612

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At 31 December 2019 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Total credit exposure not covered by collateral	Associated ECL
Derivatives	9,485	-	-	1,757	-	-	1,757	7,728	-
Loans and commitments to customers:	1,012,821	622,021	87,217	7,001	49,865	80,043	846,147	166,674	5,056
Individuals	374,718	292,701	7	417	13,317	116	306,558	68,160	1,579
Commerce and services	146,149	63,151	777	961	27,124	25,891	117,904	28,245	1,030
Construction	55,236	40,432	4	653	2,130	3,968	47,187	8,049	495
Energy	10,861	5,655	-	366	8	5	6,034	4,827	34
Financial services	8,894	-	-	123	-	3,621	3,744	5,150	7
Industrial and transportation	99,188	49,944	12	107	6,757	18,566	75,386	23,802	534
Investment companies	23,982	7,748	-	3,281	71	11,930	23,030	952	478
Public sector and non-profit organisations	15,758	958	-	7	29	-	994	14,764	29
Real estate	162,795	148,919	5	1,072	301	1,125	151,422	11,373	702
Seafood	115,240	12,513	86,412	14	128	14,821	113,888	1,352	168
Total	1,022,306	622,021	87,217	8,758	49,865	80,043	847,904	174,402	5,056
Collateral held against credit-impaired exposures									
Loans and commitments to customers:	22,616	17,100	1,481	333	846	830	20,590	2,026	5,931
Individuals	8,427	7,191	17	12	166	2	7,388	1,039	1,245
Commerce and services	4,944	2,980	102	22	561	805	4,470	474	1,864
Construction	5,219	4,919	-	197	19	7	5,142	77	261
Industrial and transportation	1,965	253	1,331	102	72	16	1,774	191	1,559
Investment companies	156	149	-	-	-	-	149	7	111
Public sector and non-profit organisations	15	14	-	-	-	-	14	1	1
Real estate	1,800	1,567	-	-	9	-	1,576	224	595
Seafood	90	27	31	-	19	-	77	13	295
Total	22,616	17,100	1,481	333	846	830	20,590	2,026	5,931

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50. Credit quality of financial assets

The following table provides the gross carrying amount of loans and credit risk exposure on loan commitments and financial guarantees. Amounts are broken down by risk class and the method by which their respective credit loss allowances (ECL) are calculated, i.e. Stage 1, 2 and 3.

The Group 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 Group uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Group 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.

Risk classes 1-4 represent low risk, risk classes 5-6 moderate risk, risk classes 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers that are in default. Unrated are loans that are yet to be rated.

Further information on the risk classes, including the mapping from risk classes to the probability of default, can be found in Section 4.2.2 of the unaudited Pillar 3 2020 Report.

The same customer can have loans and off-balance sheet commitments in Stages 1 and 2 simultaneously. However, if a customer has an exposure in Stage 3 then all other loans and commitments are classified as Stage 3 as well.

Due to the COVID-19 pandemic the Group transferred a relatively large proportion of assets from Stage 1 to Stage 2 in the first half of 2020. In addition to the move from 12-month to lifetime expected credit loss, an additional overlay factor was applied to customers in the tourism industry (see Note 3).

At 31 December 2020

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	232,806	1,209	-	234,015
Risk class 5-6	346,781	62,788	-	409,569
Risk class 7-8	217,368	80,867	-	298,235
Risk class 9	38,290	14,684	-	52,974
Risk class 10	-	-	29,247	29,247
Unrated	190	1	-	191
	835,435	159,549	29,247	1,024,231
Expected credit loss	(3,645)	(6,482)	(7,387)	(17,514)
Net carrying amount	831,790	153,067	21,860	1,006,717

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	64,781	1,341	-	66,122
Risk class 5-6	51,169	6,461	-	57,630
Risk class 7-8	10,852	16,227	-	27,079
Risk class 9	1,142	553	-	1,695
Risk class 10	-	-	809	809
Unrated	99	8	-	107
	128,043	24,590	809	153,442
Expected credit loss	(347)	(483)	(225)	(1,055)
Total	127,696	24,107	584	152,387

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At 31 December 2020	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	94,574	182,706	153,088	35,928	7,646	4	(2,874)	471,072
Commerce and services	25,813	62,494	58,182	7,121	6,402	144	(6,602)	153,554
Construction	4,809	22,332	26,078	2,130	1,064	33	(721)	55,725
Energy	5,006	3,338	670	-	-	-	(25)	8,989
Financial services	5,816	2,650	443	-	-	8	(2)	8,915
Industrial and transportation	15,557	56,578	28,547	2,895	4,039	50	(3,049)	104,617
Investment companies	868	5,171	14,695	1,599	3,628	2	(993)	24,970
Public sector and non-profit organisations	14,525	1,400	324	1	1	28	(20)	16,259
Real estate	46,297	82,945	42,299	4,057	6,950	8	(3,845)	178,711
Seafood	86,872	47,585	988	938	326	21	(438)	136,292
Total	300,137	467,199	325,314	54,669	30,056	298	(18,569)	1,159,104

At 31 December 2019

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	226,347	289	-	226,636
Risk class 5-6	388,936	1,385	-	390,321
Risk class 7-8	204,979	14,487	-	219,466
Risk class 9	33,880	7,544	-	41,424
Risk class 10	-	-	27,160	27,160
Unrated	4,676	93	154	4,923
	858,818	23,798	27,314	909,930
Expected credit loss	(3,645)	(953)	(5,700)	(10,298)
Net carrying amount	855,173	22,845	21,614	899,632

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	58,327	25	-	58,352
Risk class 5-6	58,271	253	-	58,524
Risk class 7-8	15,334	1,757	-	17,091
Risk class 9	1,095	186	-	1,281
Risk class 10	-	-	1,233	1,233
Unrated	8	5	-	13
	133,035	2,226	1,233	136,494
Expected credit loss	(403)	(55)	(231)	(689)
Total	132,632	2,171	1,002	135,805

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At 31 December 2019	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	76,119	151,224	115,042	29,537	9,517	4,530	(2,824)	383,145
Commerce and services	29,718	81,536	31,572	3,968	6,810	383	(2,894)	151,093
Construction	3,354	33,345	17,924	1,120	5,468	-	(756)	60,455
Energy	5,045	3,846	2,004	-	-	-	(34)	10,861
Financial services	8,848	30	17	-	-	6	(7)	8,894
Industrial and transportation	26,474	59,108	11,775	2,363	3,526	-	(2,093)	101,153
Investment companies	2,803	9,198	11,090	1,367	268	1	(589)	24,138
Public sector and non-profit organisations	12,761	2,733	268	11	15	15	(30)	15,773
Real estate	52,934	64,623	42,304	3,631	2,400	-	(1,297)	164,595
Seafood	66,932	43,202	4,561	708	389	1	(463)	115,330
Total	284,988	448,845	236,557	42,705	28,393	4,936	(10,987)	1,035,437

51. Loans to customers in the tourism industry likely to be vulnerable to COVID-19 pandemic

Companies susceptible to the impact of COVID-19 were classified into four groups based on an assessment of how much an increase in credit risk these companies face in the short, medium and long term. In addition, to account for the material uncertainty in the operating environment of companies in the tourism industry, not reflected in their current risk class, they are further classified into four groups based on an assessment of how vulnerable they are to various assumptions on when tourists can be expected to start visiting Iceland again. The base case assumes around 700.000 tourists in Iceland in 2021.

Impact group 1: viable even though significantly fewer tourists arrive in the year 2021
Impact group 2: viable with forbearance even though significantly fewer tourists arrive in the year 2021
Impact group 3: viable if the number of tourists in the year 2021 is similar to the base case
Impact group 4: viable if the year 2021 turns out to be better than the base case

Where the increase was found to be significant (groups 2-4), the exposure was transferred to Stage 2. In addition, an overlay factor was applied to the expected credit loss, comparable to an increase in up to three risk classes, and a higher haircut was applied to value of collateral for the higher impact groups in the more severe scenarios.

At 31 December 2020

Loans to customers in the tourism industry:	Stage 1	Stage 2	Stage 3	Total
Group 1	1,903	308	-	2,211
Group 2	-	30,503	406	30,909
Group 3	-	58,610	2,579	61,189
Group 4	-	3,317	3,612	6,929
	1,903	92,738	6,597	101,238
Expected credit loss	(24)	(4,483)	(2,529)	(7,036)
Net carrying amount	1,879	88,255	4,068	94,202

Off-balance sheet loan commitments and financial guarantees to customers in the tourism industry:

	Stage 1	Stage 2	Stage 3	Total
Group 1	50	2	-	52
Group 2	-	13,416	51	13,467
Group 3	-	5,118	163	5,281
Group 4	-	429	17	446
	50	18,965	231	19,246
Expected credit loss	(3)	(363)	(101)	(467)
Total	47	18,602	130	18,779

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52. Forbearance

When restructuring or modification measures are believed to be more appropriate than collection procedures, the Group offers several debt relief measures and restructuring frameworks for customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants.

The relationship between forbearance and stages is discussed in Note 67.4.

Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for a loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:
- All of the customer's facilities have to be considered performing; and
- The customer does not have any contract that is more than 30 days past due; and
- The probation period of two years has passed from the date of the forbearance event; and
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period

Because of the COVID-19 pandemic, the Group entered into an agreement with other financial institutions and lenders in Iceland to provide a moratorium for customers, uniformly executed across institutions. In the interim financial statements for the third quarter of 2020 the Group showed the extent of the payment moratoria granted by the Group under these initiatives. The agreement expired on 30 September 2020 and all moratoria under it has expired. Further extensions of moratoria has been granted on a case-by-case basis and is now classified as forbearance.

The tourism industry is an important economic sector in Iceland but due to the nature of tourism, its effects are not limited to hotels, car rentals and tour guides. The Group therefore monitors the tourism industry internally as a quasi-sector instead of a new separate sector. Real estate companies that do not operate directly in the tourism sector but rely in part on rental income from such activities explain around half of the forbearance amount for companies not in tourism.

The following table provides a summary of the Group's forborne assets. The loans that previously were in payment moratorium and are now forborne are shown separately.

At 31 December 2020

	Stage 1	Stage 2	Stage 3	Total
Individuals	932	5,249	2,068	8,249
- thereof previously in COVID-19 moratoria	83	3,031	55	3,169
Companies	209	104,523	13,608	118,340
- In the tourism quasi-sector	-	62,295	5,747	68,042
- thereof previously in COVID-19 moratoria	-	54,945	321	55,266
- Other than the tourism quasi-sector	209	42,228	7,861	50,298
- thereof previously in COVID-19 moratoria	40	24,038	35	24,113
Gross carrying amount	1,141	109,772	15,676	126,589

	Stage 1	Stage 2	Stage 3	Total
Individuals	(10)	(127)	(176)	(313)
- thereof previously in COVID-19 moratoria	-	(62)	(1)	(63)
Companies	(1)	(4,114)	(4,147)	(8,262)
- In the tourism quasi-sector	-	(2,787)	(1,888)	(4,675)
- thereof previously in COVID-19 moratoria	-	(2,508)	(136)	(2,644)
- Other than the tourism quasi-sector	(1)	(1,327)	(2,259)	(3,587)
- thereof previously in COVID-19 moratoria	-	(462)	(1)	(463)
Expected credit loss	(11)	(4,241)	(4,323)	(8,575)

At 31 December 2019

	Stage 1	Stage 2	Stage 3	Total
Individuals	1,615	1,102	1,372	4,089
Companies	13,212	8,469	8,289	29,970
Gross carrying amount	14,827	9,571	9,661	34,059

	Stage 1	Stage 2	Stage 3	Total
Individuals	(12)	(41)	(182)	(235)
Companies	(77)	(249)	(2,167)	(2,493)
Expected credit loss	(89)	(290)	(2,349)	(2,728)

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53. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

	31.12.2020	31.12.2019
Property and land	1,754	378
Industrial equipment and vehicles	86	81
Total	1,840	459

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations.

54. Write-offs

When the Group has no reasonable expectations of recovering a credit exposure or when it is uneconomical to pursue legal collection, the financial asset is written off. A write-off does not change the debt obligation which is therefore still subject to enforcement activity. Any recoveries of amounts previously written off are credited to the income statement.

Gross carrying amount written off and still subject to enforcement activity	2020	2019
Individuals	393	578
Companies	1,091	1,253
Total	1,484	1,831

55. Large exposures disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group'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 regulation no. 233/2017. The Group has internal criteria that define connections between clients. These criteria reflect the Group's interpretation of Article (1)(a) of the Act on Financial Undertakings no. 161/2002, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects. After mitigating effects, the Group currently has one large exposure. No large exposure is therefore above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects.

At 31 December 2020

Groups of connected clients:	Before	After
Group 1	65%	-
Group 2	13%	10%

At 31 December 2019

Groups of connected clients:	Before	After
Group 1	75%	-

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56. Liquidity risk

The Group 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.

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

57. Liquidity coverage and Net stable funding ratio

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the Financial Supervisory Authority of the Central Bank's guidelines no. 2/2010 on best practices in liquidity management and liquidity coverage ratio rules no. 266/2017.

The following tables show the NSFR and the LCR for the Group at year-end 2020 and 2019.

Net stable funding ratio	31.12.2020	31.12.2019
For all currencies	123%	119%
Foreign currencies	179%	156%

Liquidity coverage ratio	31.12.2020	31.12.2019
For all currencies	196%	155%
Domestic currency	95%	110%
Foreign currencies	463%	325%

At 31 December 2020	For all currencies		Domestic currency		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	182,104	182,104	138,078	138,078	44,027	44,027
Liquid assets level 2	14,648	2,941	14,470	2,941	178	-
Total liquid assets	196,752	185,045	152,548	141,019	44,205	44,027
Deposits	542,123	147,611	472,073	120,974	70,049	26,636
Debt issued	2,271	2,271	47	47	2,225	2,225
Other outflows	99,949	44,756	68,500	35,605	31,449	9,151
Total outflows	644,343	194,638	540,620	156,626	103,723	38,012
Short-term deposits with other banks**	88,495	88,328	2,077	2,077	86,419	86,252
Other inflows	29,842	11,981	21,342	6,221	8,500	5,760
Restrictions on inflows	-	-	-	-	(17,126)	(63,503)
Total inflows	118,337	100,309	23,419	8,298	77,793	28,509
Liquidity coverage ratio		196%		95%		463%

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At 31 December 2019	For all currencies		Domestic currency		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	157,080	157,080	125,222	125,222	31,858	31,858
Liquid assets level 2	11,942	6,271	8,216	5,751	3,727	520
Total liquid assets	169,022	163,351	133,438	130,973	35,585	32,378
Deposits	482,322	139,354	404,233	105,393	78,089	33,961
Debt issued	1,361	1,361	711	711	650	650
Other outflows	81,493	30,997	63,481	25,749	18,012	5,248
Total outflows	565,176	171,712	468,425	131,853	96,751	39,859
Short-term deposits with other banks**	54,203	52,335	2,860	2,074	51,343	50,261
Other inflows	33,984	14,213	27,697	10,655	6,287	3,558
Restrictions on inflows	-	-	-	-	-	(23,925)
Total inflows	88,187	66,548	30,557	12,729	57,630	29,894
Liquidity coverage ratio		155%		110%		325%

*Level 1 liquid assets include cash and balances with the Central Bank, domestic bonds eligible as collateral against borrowing at the Central Bank and foreign government bonds in accordance with rules no. 266/2017 on liquidity ratio.

**Short-tem deposits with other banks with maturity less than 30 days.

Deposits by liquidity coverage ratio category

The Group's deposits are categorised by counterparty according to the Liquidity Coverage Ratio (LCR) standard. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classified as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme.

Increase in compensation according to the insurance guarantee scheme in Iceland and the Bank's update of its internal definition of established business relationships caused the amount of stable deposits to increase compared to year-end 2019.

	Deposits maturing within 30 days					
At 31 December 2020	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	120,510	14%	247,625	5%	75,971	444,106
Operational relationships	3,155	25%	-	5%	-	3,155
Corporations	77,705	40%	1,959	20%	24,965	104,629
Sovereigns, Central Bank and public sector entities	6,340	40%	1,174	20%	934	8,448
Pension funds	39,105	100%	-	-	23,754	62,859
Domestic financial entities	38,284	100%	-	-	41,647	79,931
Foreign financial entities	6,266	100%	-	-	9,819	16,085
Total	291,365		250,758		177,090	719,213

	Deposits maturing within 30 days					
At 31 December 2019	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	228,447	12%	83,773	5%	78,870	391,090
Operational relationships	2,446	25%	-	5%	-	2,446
Corporations	73,739	40%	337	20%	24,589	98,665
Sovereigns, Central Bank and public sector entities	6,813	40%	253	20%	620	7,686
Pension funds	35,405	100%	-	-	24,869	60,274
Domestic financial entities	28,494	100%	-	-	46,371	74,865
Foreign financial entities	8,038	100%	-	-	6,174	14,212
Total	383,382		84,363		181,493	649,238

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58. Maturity analysis of assets and liabilities

The following tables show the maturity profile of the Group's financial assets and the undiscounted cash flows of its financial liabilities.

Maturity classification of assets is based on contractual maturity. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

The tables show undiscounted contractual payments of principal and interest for the Group'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.

The contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative and a positive carrying amount at the reporting date. 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.

At 31 December 2020	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	78,948	29,600	48,060	-	-	1,288	-	78,948
Loans to credit institutions	89,920	46,102	43,818	-	-	-	-	89,920
Bonds and debt instruments	128,216	-	38,169	34,776	48,047	7,224	-	128,216
Loans to customers	1,006,717	2,562	81,090	96,084	334,520	492,461	-	1,006,717
Shares and equity instruments	14,851	-	-	-	-	-	14,851	14,851
Other financial assets	3,692	2,483	560	643	6	-	-	3,692
Total financial assets	1,322,344	80,747	211,697	131,503	382,573	500,973	14,851	1,322,344
Deposits from CB and credit institutions	39,758	6,073	20,044	10,278	3,368	-	-	39,763
Deposits from customers	679,455	539,932	65,532	56,764	23,409	27,016	-	712,653
Debt issued and other borrowed funds	387,274	-	12,677	31,569	327,003	93,434	-	464,683
Subordinated loans	27,194	-	176	477	3,096	29,903	-	33,652
Other financial liabilities:	9,721	3,570	1,453	1,227	1,783	2,123	-	10,156
Lease liabilities	3,962	-	123	369	1,783	2,123	-	4,398
Other liabilities	5,759	3,571	1,330	858	-	-	-	5,759
Total financial liabilities	1,143,402	549,575	99,882	100,315	358,659	152,476	-	1,260,907

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	41,288	46,627	39,643	-	-	127,558
Outflow	-	(38,823)	(45,090)	(36,516)	-	-	(120,429)
Total	-	2,465	1,537	3,127	-	-	7,129
Net settled derivatives	-	90	-	-	-	-	90
Total derivative financial assets	-	2,555	1,537	3,127	-	-	7,219
Gross settled derivatives							
Inflow	-	29,311	18,714	29,943	-	-	77,968
Outflow	-	(30,236)	(20,113)	(33,957)	-	-	(84,306)
Total	-	(925)	(1,399)	(4,014)	-	-	(6,338)
Net settled derivatives	-	(1,752)	-	-	-	-	(1,752)
Total derivative financial liabilities	-	(2,677)	(1,399)	(4,014)	-	-	(8,090)
Total net financial assets and financial liabilities	(468,828)	117,047	34,124	31,055	348,497	14,851	76,746

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At 31 December 2019	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	146,638	28,978	115,981	-	-	1,679	-	146,638
Loans to credit institutions	54,376	20,719	33,656	-	-	-	-	54,375
Bonds and debt instruments	52,870	7,768	23,998	10,120	10,983	-	-	52,869
Loans to customers	899,632	2,972	88,446	87,462	303,668	417,083	-	899,631
Shares and equity instruments	18,426	-	-	-	-	-	18,426	18,426
Other financial assets	5,757	1,889	525	118	17	-	3,259	5,808
Total financial assets	1,177,699	62,326	262,606	97,700	314,668	418,762	21,685	1,177,747
Deposits from CB and credit institutions	30,925	1,992	16,363	8,468	4,580	-	-	31,403
Deposits from customers	618,313	453,959	78,232	54,994	16,612	62,222	-	666,019
Debt issued and other borrowed funds	306,381	-	6,991	24,861	267,776	90,610	-	390,238
Subordinated loans	22,674	-	158	463	2,865	26,482	-	29,968
Other financial liabilities:	24,772	17,581	2,124	1,276	1,759	2,448	-	25,188
Lease liabilities	4,256	-	116	349	1,759	2,448	-	4,672
Other liabilities	20,516	17,581	2,008	927	-	-	-	20,516
Total financial liabilities	1,003,065	473,532	103,868	90,062	293,592	181,762	-	1,142,816

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	92,680	28,583	74,731	-	-	195,994
Outflow	-	(82,832)	(27,964)	(73,544)	-	-	(184,340)
Total	-	9,848	619	1,187	-	-	11,654
Net settled derivatives	-	273	-	-	-	-	273
Total derivative financial assets	-	10,121	619	1,187	-	-	11,927
Gross settled derivatives							
Inflow	-	57,542	36,133	43,218	-	-	136,893
Outflow	-	(59,615)	(37,222)	(44,915)	-	-	(141,752)
Total	-	(2,073)	(1,089)	(1,697)	-	-	(4,859)
Net settled derivatives	-	(323)	-	-	-	-	(323)
Total derivative financial liabilities	-	(2,396)	(1,089)	(1,697)	-	-	(5,182)
Total net financial assets and financial liabilities	(411,206)	171,255	9,346	23,960	237,000	21,685	52,040

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Off-balance sheet liabilities

The following tables show the amount of contractual obligations of off-balance sheet liabilities that the Group 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 Group'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 Group could be required to fulfil these obligations instantaneously.

At 31 December 2020	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	23,189	-	-	-	-	-	23,189
Undrawn loan commitments	40,026	-	-	-	-	-	40,026
Undrawn overdrafts	56,746	-	-	-	-	-	56,746
Credit card commitments	32,427	-	-	-	-	-	32,427
Total off-balance sheet liabilities	152,388	-	-	-	-	-	152,388
At 31 December 2019							
Financial guarantees	18,861	-	-	-	-	-	18,861
Undrawn loan commitments	35,443	-	-	-	-	-	35,443
Undrawn overdrafts	51,338	-	-	-	-	-	51,338
Credit card commitments	30,163	-	-	-	-	-	30,163
Total off-balance sheet liabilities	135,805	-	-	-	-	-	135,805

59. Market risk

The Group 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, foreign exchange rates, equity prices, CPI-indexation and commodity prices. Sources of market risk are imbalances in the Group's balance sheet and open positions in bonds, currencies and equities. Derivative contracts are also potential sources of market risk.

Market risk within the Group can broadly be split into two categories, trading book and banking book. The trading book includes market risk exposures related, directly or indirectly, to the Group's short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. 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. The banking book includes market risk exposures related to securities held for long-term investment purposes, unlisted securities or holdings in subsidiaries or affiliates. A large part of the banking book market risk is due to mismatches in the composition of assets and liabilities, for example with respect to currencies, interest rates, CPI-indexation or other factors that can affect the Group's earnings or earnings volatility. These mismatches are reported to management and are subject to internal and regulatory limits.

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60. Interest rate risk

Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates. Sensitivity measures like Basis Point Value (BPV) are used 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.

Interest rate risk in the trading book

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing and Construction Authority which are guaranteed by the Icelandic Government, domestic municipality bonds, and covered bonds issued by other Icelandic banks. Bonds and bills in the Group's liquidity portfolio are also categorised in the trading book. In the following table the total market value (MV) of long and short positions may not be the same as reported in Note 19 since netting between short and long positions is not applied here.

	31.12.2020			31.12.2019		
Trading bonds and debt instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	4,103	1.87	(0.77)	1,143	6.84	(0.78)
Non-indexed	86,829	0.66	(5.70)	31,855	0.41	(1.29)
Total	90,932	0.71	(6.47)	32,998	0.63	(2.07)

	31.12.2020			31.12.2019		
Trading bonds and debt instruments, short positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	224	6.00	0.12	150	6.00	0.10
Non-indexed	351	5.00	0.17	615	4.00	0.28
Total	575	5.39	0.29	765	4.39	0.38
Net position of trading bonds and debt instruments	90,357	0.68	(6.18)	32,233	0.54	(1.69)

The following table shows the interest rate sensitivity of the Group's trading book from a parallel 100 basis points change in all yield curves.

Sensitivity analysis for trading bonds and debt instruments		31.12.2020		31.12.2019	
		Effect on profit or (loss)			
Currency	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	78	(78)	87	(87)
ISK, non-indexed	100	393	(393)	44	(44)
EUR	100	108	(108)	40	(40)
USD	100	12	(12)	32	(32)
Other total	100	61	(61)	9	(9)
Total		652	(652)	212	(212)

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Interest rate risk in the banking book

Interest rate risk in the banking book arises from the Group'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 Group's assets and liabilities are of different maturities and are priced relative to different interest rates.

The following table shows the interest sensitivity of the Group's banking book from a parallel 100 basis points change in all yield curves, with all other variables held constant, categorised by the date of next interest rate reset.

Sensitivity analysis for interest rate risk in the banking book

At 31 December 2020

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	-	(108)	236	(2,554)	4,388	(1,232)	730
ISK, non-indexed	(13)	(28)	(43)	(945)	(218)	(4)	(1,251)
EUR	60	(58)	(34)	123	-	(1)	90
SEK	(5)	-	-	-	-	-	(5)
USD	27	-	-	-	-	(1)	26
Other	(2)	(12)	-	(8)	-	(6)	(28)
Total	67	(206)	159	(3,384)	4,170	(1,244)	(438)

At 31 December 2019

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	55	60	(442)	(1,668)	1,995	193	193
ISK, non-indexed	7	(12)	11	89	(10)	(9)	76
EUR	(17)	(20)	(29)	118	-	(2)	50
SEK	10	-	-	-	-	-	10
USD	(42)	-	-	-	-	(1)	(43)
Other	12	(11)	-	41	-	(6)	36
Total	25	17	(460)	(1,420)	1,985	175	322

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61. Currency risk

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 Group'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.

Series C preferred shares in Visa Inc., which the Group holds, are included in the currency imbalance even though the shares are classified as held for sale.

Currency analysis at 31 December 2020

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	779	281	148	45	17	54	56	101	31	119	1,631
Loans to credit institutions	28,586	44,519	1,301	422	248	880	9,487	415	375	100	86,333
Bonds and debt instruments	25,052	3,932	7	-	-	3,894	11,195	-	-	-	44,080
Loans to customers	127,317	31,584	1,160	521	3,330	84	3,215	2,788	7,468	29	177,496
Shares and equity instruments	32	1,551	338	-	-	152	32	-	-	-	2,105
Other assets	606	124	-	-	-	34	-	-	3	-	767
Total assets	182,372	81,991	2,954	988	3,595	5,098	23,985	3,304	7,877	248	312,412
Liabilities											
Deposits from credit institutions	10,958	788	23	-	-	-	1	-	-	-	11,770
Deposits from customers	26,757	30,607	3,917	517	386	1,017	3,132	2,277	392	20	69,022
Derivative instruments and short positions	-	-	-	-	-	9	-	-	-	-	9
Debt issued and other borrowed funds	143,255	-	-	-	-	38,589	21,169	-	-	-	203,013
Subordinated loans	-	-	-	-	-	27,194	-	-	-	-	27,194
Other liabilities	415	114	-	-	-	19	-	29	1	-	578
Total liabilities	181,385	31,509	3,940	517	386	66,828	24,302	2,306	393	20	311,586
Net on-balance sheet position	987	50,482	(986)	471	3,209	(61,730)	(317)	998	7,484	228	826
Net off-balance sheet position	463	(46,840)	920	(484)	(3,198)	61,672	268	(829)	(7,468)	(276)	4,228
Net position	1,450	3,642	(66)	(13)	11	(58)	(49)	169	16	(48)	5,054

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Currency analysis at 31 December 2019

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	942	319	210	52	24	51	73	114	58	123	1,966
Loans to credit institutions	11,689	25,740	1,650	378	534	116	9,707	1,294	272	687	52,067
Bonds and debt instruments	12,930	10,937	3	-	-	-	8,232	-	-	-	32,102
Loans to customers	112,185	29,486	2,037	581	3,185	3	3,408	635	6,005	33	157,558
Shares and equity instruments	31	3,371	419	-	-	-	27	-	-	-	3,848
Other assets	390	1,866	338	6	-	73	2	20	-	458	3,153
Total assets	138,167	71,719	4,657	1,017	3,743	243	21,449	2,063	6,335	1,301	250,694
Liabilities											
Deposits from credit institutions	9,145	558	1	-	-	-	-	-	-	-	9,704
Deposits from customers	32,247	27,939	3,810	385	395	874	3,317	3,617	453	42	73,079
Debt issued and other borrowed funds	91,809	-	-	-	-	37,768	19,565	-	-	-	149,142
Subordinated loans	-	-	-	-	-	22,674	-	-	-	-	22,674
Other liabilities	1,728	944	558	35	3	162	5	47	2	665	4,149
Total liabilities	134,929	29,441	4,369	420	398	61,478	22,887	3,664	455	707	258,748
Net on-balance sheet position	3,238	42,278	288	597	3,345	(61,235)	(1,438)	(1,601)	5,880	594	(8,054)
Net off-balance sheet position	(4,344)	(41,574)	(231)	(610)	(3,345)	61,127	1,255	1,726	(5,840)	(203)	7,961
Net position	(1,106)	704	57	(13)	-	(108)	(183)	125	40	391	(93)

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The following table shows the effect of a 10% depreciation or appreciation of foreign exchange rates where the Group had positions at year-end, with all other variables held constant.

Sensitivity analysis for currency risk	31.12.2020		31.12.2019	
	Effect on profit or (loss)			
Currency	-10%	10%	-10%	10%
EUR	(145)	145	111	(111)
USD	(364)	364	(70)	70
GBP	7	(7)	(6)	6
CHF	1	(1)	1	(1)
JPY	(1)	1	-	-
SEK	6	(6)	11	(11)
NOK	5	(5)	18	(18)
DKK	(17)	17	(13)	13
CAD	(2)	2	(4)	4
Other foreign currencies	5	(5)	(39)	39
Total	(505)	505	9	(9)

62. Shares and equity instruments

The Group's equity exposure in the trading book arises from flow trading and market making with shares listed on the Nasdaq Iceland Stock Exchange. Shares and equity instruments in the banking book are classified as mandatorily at fair value through profit or loss or are classified as held for sale.

The following table shows how a 10% shift in equity prices would affect the Group's equity and net financial income. Securities used for hedging are excluded.

Sensitivity analysis for shares and equity instruments		31.12.2020		31.12.2019	
		Effect on profit or (loss)			
Portfolio	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading book	10%	(113)	113	(169)	169
Banking book	10%	(462)	462	(806)	806
Total		(575)	575	(975)	975

63. Inflation risk

The Group is exposed to inflation risk since the value of CPI-linked assets exceeds CPI-linked 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 affect profit and loss. A 1% increase in the index would lead to an ISK 262 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

The off-balance sheet position of certain derivatives were incorrect in the year-end 2019 figures. Off-balance sheet liabilities positions have consequently been adjusted downwards by ISK 11,400 million. The year-end 2019 CPI imbalance therefore increased from ISK 9,260 million to ISK 20,660 million.

	31.12.2020	31.12.2019
Bonds and debt instruments	4,684	2,103
Loans to customers	268,062	295,725
Total CPI-linked assets	272,746	297,828

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63. Cont'd

	31.12.2020	31.12.2019
Deposits from customers	90,353	98,766
Debt issued and other borrowed funds	136,487	125,975
Off-balance sheet position	19,725	52,427
Total CPI-linked liabilities	246,565	277,168
CPI imbalance	26,181	20,660

64. Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. However, the Group is subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and collateral requirements. Other derivatives held for trading or for other purposes are insignificant.

65. Capital management

The following tables show the capital base, risk exposure amount, the resulting capital ratios, and leverage for the Group at 31 December 2020 and 31 December 2019.

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through Act no. 161/2002 on Financial Undertakings and regulation no. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

Article 501 of the capital requirements regulation (EU) no. 575/2013 of the European Parliament came into effect in Iceland on 1 January 2020. This article stipulates capital requirements deduction for credit risk on exposures to SMEs and lowers the risk exposure amount by ISK 13.7 billion as of 31 December 2020, corresponding to a 30 basis point increase in the Group's capital ratio.

EU regulation no. 2017/2395 regarding transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds, was ratified into Icelandic law in May 2020. The regulation allows for the phasing in of capital impacts due to IFRS 9, allowing institutions to include a predefined level of provisions as part of CET1 capital. Íslandsbanki has elected to make use of the transitional arrangements, which will add ISK 5.1 billion to CET1, corresponding to an increase of 55 basis points in the Group's capital ratio.

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the Financial Supervisory Authority of the Central Bank, applicable as of 22 September 2020, the overall capital requirement is 17.0%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The minimum leverage ratio for Icelandic financial institutions is 3%.

	31.12.2020	31.12.2019
CET1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,181	7,065
Retained earnings	113,529	105,569
Non-controlling interests	1,494	2,428
IFRS 9 reversal due to transitional rules	5,164	-
Fair value changes due to own credit standing	238	392
Tax assets	(259)	(476)
Intangible assets	(3,478)	(4,330)
Total CET1 capital	187,869	175,648

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65. Cont'd

	31.12.2020	31.12.2019
Tier 2 capital		
Qualifying subordinated loans	27,194	22,674
Total capital base	215,063	198,322
Risk exposure amount		
- due to credit risk	830,141	789,180
- due to market risk	16,626	7,919
Market risk, trading book	11,306	6,488
Currency risk	5,320	1,431
- due to credit valuation adjustment	1,728	2,027
- due to operational risk	85,026	85,424
Total risk exposure amount	933,521	884,550
Capital ratios		
Tier 1 ratio	20.1%	19.9%
Total capital ratio	23.0%	22.4%
Leverage ratio		
Exposure amount		
On-balance sheet exposures	1,333,807	1,189,062
Off-balance sheet exposures	41,067	38,849
Derivative exposures	9,922	9,461
Leverage ratio total exposure measure	1,384,797	1,237,372
Tier 1 capital	187,869	175,648
Leverage ratio	13.6%	14.2%

66. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Group’s definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board has approved an Operational Risk Policy which outlines the Bank's framework for operational risk management. Risk Management is responsible for implementing the Bank’s operational risk framework, for developing, maintaining the Operational Risk Policy and for communicating the policy to the Bank‘s employees.

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67. Significant accounting policies

The accounting policies set out below have been applied consistently by the Group for the periods presented in these consolidated financial statements.

67.1 Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries. The Group consolidates its subsidiaries on the basis of control.

Control

Subsidiaries are investments that the Group has control over. The Group controls an investment when the Group is exposed, or has rights, to variable returns from its involvement with the investment and has the ability to affect those returns through its power over the investment. The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities and the ability to exercise its right.

Generally, there is a presumption that a majority of voting rights results in control. However, in individual circumstances, the Group may still exercise control with less than 50% shareholding, or may not be able to exercise control with over 50% of an entity's shares.

When assessing whether the Group has power over the investment and therefore controls the variability of this return, the Group considers all relevant facts and circumstances, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

The Group reassesses its control over subsidiaries on a regular basis.

Business combinations

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

Consolidation

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group no longer has control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group balances, income and expenses relating to transactions between group entities are eliminated in full on consolidation. This also applies to subsidiaries classified as disposal groups held for sale (see Note 67.11).

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

Non-controlling interests

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination the Group measures non-controlling interests, at the acquisition date, at either fair value or their proportionate share of the acquiree's identifiable net assets.

The Group presents non-controlling interests within equity in the statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki and to non-controlling interests even if this results in the non-controlling interests having a deficit balance. This also applies to subsidiaries classified as disposal groups held for sale.

Loss of control

If the Group loses control of a subsidiary, it derecognises the related assets, liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss in the line item "Other operating income", or in the line item "Discontinued operations, net of income tax" if the subsidiary is classified as disposal group held for sale.

Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

67.1 Cont'd

Funds management

The Group acts as a manager for Undertakings for Collective Investment in Transferable Securities (UCITS) and investment funds as well as other funds for collective investment that accept capital from investors. Such funds are financed by issuing unit share certificates or shares. The Group does not have any contractual financial responsibility with respect to such custom units. The funds are not consolidated unless they are under the control of the Group.

The Group reviews all the facts and circumstances in order to decide if these funds should be consolidated. The Group is deemed to be a principal and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or guarantee, and is able to influence the returns of the funds by exercising its power.

67.2 Investments in associates

Associates are entities over which the Group has significant influence to participate in the financial and operating policy decisions of an entity but does not have control over those policies. It is presumed that the Group has significant influence if the Group holds 20-50% of the voting power of an entity. Considerations made in determining significant influence are similar to those used to determine control over subsidiaries (see Note 67.1).

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. After the acquisition date the carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets. Distributions received from an associate reduce the carrying amount of the investment. If goodwill is in place related to acquisitions of associates then it is included in the carrying amount of the investments and is not tested for impairment separately.

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases.

When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and the impairment loss is recognised in profit or loss.

Upon loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss in the line item "Other operating income".

Income and expenses from investments in associates are recognised in profit or loss in the line item "Other operating income".

67.3 Foreign currencies

The financial statements of each of the Group's entities are measured using the functional currency of the respective entity.

Foreign currency transactions

On initial recognition transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. At the end of each reporting period monetary assets and liabilities denominated in foreign currencies are retranslated into functional currencies using the closing rate. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the functional currency using the exchange rate at the date when the fair value was determined.

All foreign currency differences arising on currency translation from one currency to another are recognised in profit or loss in the line item "Net foreign exchange gain (loss)".

67.4 Financial assets and financial liabilities

Recognition

The Group recognises a financial asset and a financial liability in its statement of financial position on the trade date, which is the date on which the Group becomes party to the contractual provisions of the instrument, except for loans which are recognised on the date when cash is advanced by the Group to the borrowers. At initial recognition, the Group measures a financial asset or a financial liability at its fair value plus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability.

Derecognition

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

The Group derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

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

The Group does not derecognise from its statement of financial position securities which the Group sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Modifications

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value.

Classification and measurement of financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories:
• Financial assets at amortised cost
• Financial assets at fair value through other comprehensive income
• Financial assets at fair value through profit or loss
• Derivative assets held for hedging

The measurement basis of individual financial assets is determined based on an assessment of the cash flow characteristics of the assets and the business models under which they are managed.

The business models

The business models are determined by the Group's key management personnel in the way that assets are managed and their performance is reported to them. The Group determines its business models at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. This condition is not an instrument-by-instrument approach to classification, but is determined at a higher level of aggregation. The Group's business models fall into the following three categories: Held to collect, Held to collect and for sale, and Other fair value business models, where assets are held for trading or managed on a fair value basis and are neither Held to collect nor Held to collect and for sale.

67.4 Cont'd

Solely payments of principal and interest (SPPI)

Financial assets held within the business models Held to collect and Held to collect and for sale, are assessed to evaluate if their contractual cash flows are comprised of solely payments of principal and interest. SPPI payments are those which are consistent with a basic lending arrangement. Principal is the fair value of the financial asset at initial recognition and changes over the life of the financial asset, for example if there are repayments of principal. Interest relates to basic lending returns, including compensation for the time value of money and credit risk associated with the principal amount outstanding over a period of time. Interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs), as well as a profit margin that is consistent with a basic lending arrangement.

Where the contractual terms introduce exposure to risk or variability of cash flows that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

Financial assets at amortised cost

A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows, i.e. Held to collect.

Financial assets at amortised cost are measured using the effective interest method. Amortised cost is calculated by taking into account the amount at which the assets are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment. Accrued interest is included in the carrying amount of the financial asset in the statement of financial position. Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

Financial assets at fair value through other comprehensive income (FVOCI)

For shares and equity instruments that are not held for trading, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. This election is made on an instrument-by-instrument basis. Shares and equity instruments at FVOCI are not subject to an impairment assessment. Dividends are to be presented in profit or loss, as long as they represent a return on investment. On derecognition there is no recycling of fair value gains and losses to profit or loss.

Financial assets at fair value through profit or loss (FVTPL)

Financial assets classified at fair value through profit or loss are all other financial assets which are not classified at amortised cost or at fair value through other comprehensive income. This includes financial assets classified mandatorily at fair value through profit or loss and financial assets which are irrevocably designated by the Group at initial recognition as at fair value through profit or loss that would otherwise meet the requirements to be measured at amortised cost or at FVOCI. The Group designates financial assets as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise. During the year the Group did not classify any financial assets as designated at fair value through profit or loss.

Financial assets at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned, which is recognised in the line item "Interest income" and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)".

Derivative assets held for hedging

Derivative assets held for hedging consist of derivatives with positive fair value which are designated and accounted for as hedging instruments (see Note 67.7).

Classification and measurement of financial liabilities

For the purpose of measuring its financial liabilities, the Group classifies them at inception in one of the following categories, except for loan commitments and financial guarantees (see Note 67.12):

- Financial liabilities at amortised cost
- Financial liabilities mandatorily at fair value through profit or loss
- Financial liabilities designated as at fair value through profit or loss
- Derivative liabilities held for hedging

67.4 Cont'd

Financial liabilities at amortised cost
Financial liabilities at amortised cost are non-derivative financial liabilities. Financial liabilities at amortised cost include deposits, debt issued and other borrowed funds, and subordinated loans.

Financial liabilities at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums and fees and costs that are an integral part of the effective interest rate). Accrued interest is included in the carrying amount of the liabilities in the statement of financial position.

The amortised cost of certain bonds issued by the Group, which are designated as hedged items in qualifying fair value hedge relationships, is adjusted for changes in the fair value of the bonds attributable to interest rate risk (see Note 67.7).

Financial liabilities mandatorily at fair value through profit or loss
Financial liabilities mandatorily at fair value through profit or loss are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities mandatorily at fair value through profit or loss consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities mandatorily at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Financial liabilities designated as at fair value through profit or loss
Financial liabilities designated as at fair value through profit or loss are recognised at fair value and changes in fair value attributable to changes in the credit risk of those liabilities are recognised in other comprehensive income and are not subsequently reclassified to profit or loss. The remaining fair value changes are included in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" using the contractual interest rate and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

The Group calculates the fair value attributable to changes in credit risk as the difference between the changes in fair value of the financial liability and the amount of changes in fair value attributable to changes in market interest rates. The change in fair value attributable to changes in market interest rates on financial liabilities is calculated by discounting contractual cash flows at the end of the period with the discount rate of the appropriate market interest rate.

Upon initial recognition, the Group determines if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, if applicable the whole fair value change is presented in profit or loss.

Derivative liabilities held for hedging
Derivative liabilities held for hedging consist of derivatives with negative fair value which are designated and accounted for as hedging instruments (see Note 67.7).

Reclassification

Financial assets are reclassified between measurement categories if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the Group's operations.
Financial liabilities are not reclassified.

Determination of fair value

The fair value of a financial instrument is the transaction price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the reporting date.

67.4 Cont'd

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which observable market prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate.

Periodically, the Group tests the valuation techniques and calibrates against historical data and using prices from observable current market transactions for the same instrument, or based on other available observable market data.

Changes in the fair value of financial assets and financial liabilities are recognised in profit or loss in the line item "Net financial income (expense)".

The Group has an established control framework with respect to the measurement of fair values. The business unit owning the positions is responsible for their valuations and for submitting the valuation to the Bank's Investment Committee for approval. Risk Management provides an independent review of the results, the valuation methods used and of the use of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's Investment Committee.

Impairment of financial assets

The impairment model of IFRS 9 is forward-looking and impairment under IFRS 9 should reflect a probability weighted average of possible outcomes. In addition, the expected credit loss model in IFRS 9 employs a dual measurement approach, under which the loss allowance for expected credit losses (ECL) is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk (SICR) of the financial instrument since initial recognition. To satisfy the provisions of the IFRS 9 standard, a significant amount of modelling must be involved. The models which the Group uses for the calculation of the impairment amount are developed according to the Group's modelling framework. This framework imposes structure on the initial model development work, the model documentation including educational material as needed for users, the approval process for models, the implementation of models and the lifetime support for models, including validation and back-testing. The Group's impairment process, which encompasses all the steps needed to derive the appropriate impairment allowance for each accounting period, is documented and approved by the All Risk Committee.

Stage assignment

At each reporting date, all assets subject to the impairment methodology must be divided into three groups, termed "Stages", reflecting the extent of credit deterioration since initial recognition. This division then has an effect on how the impairment is measured and how interest is recognised.

Stage 1

All assets that have not experienced an SICR are assigned to Stage 1. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from credit events occurring within 12 months of the reporting date (12- month ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 2

Assets that the Group determines to have experienced an SICR, but are not credit-impaired, are classified as Stage 2. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from all credit events occurring within the expected lifetime of the assets (lifetime ECL). Interest is recognised on the gross carrying amount of the assets.

The Group's definition of an SICR is on the level of an individual asset. The Group assesses that there has been a significant increase in credit risk of an asset if the probability of a credit impairment event, i.e. transfer to Stage 3, occurring over the lifetime of the asset has increased significantly from the origination of the assets. For this purpose, origination does not refer to any modification events which have not resulted in derecognition of the asset. The assessment is based on a defined set of triggers. This includes, as a backstop, the trigger that the asset is more than thirty days past due. Other triggers are internal assessments of outlook, events such as forbearance events which are less severe than a credit event, external credit related information and a significant deterioration in risk assessment compared with the risk assessment done in relation to the origination of the asset. The definition of SICR depends only on the probability of a credit event occurring, it does not take into account collateralisation or any other information related to the expected loss arising from the event. As soon as all triggers for Stage 2 for a particular asset are no longer activated then the asset moves back to Stage 1. Additionally, assets are classed as forborne for two years after a forbearance event has occurred, but forbearance events only cause assets to be in Stage 2 for twelve months and then they migrate back to Stage 1 unless other triggers apply.

67.4 Cont'd

The Group does not employ the low credit risk exemption in the Stage assignment process. In alignment with its operating procedures, the Group has chosen as its accounting policy to measure the impairment allowance for lease receivables at an amount equal to the lifetime ECL only for those assets which have an SICR or are credit-impaired. For other lease receivables the impairment allowance is equal to the 12-month ECL.

Stage 3

This Stage is for assets which are credit-impaired according to the Group's assessment. These assets are therefore experiencing an ongoing credit event. Thus, the 12-month ECL and lifetime ECL are the same amount and this amount is recognised as impairment allowance. For assets in this Stage, interest is recognised on the net carrying amount of assets, i.e. net of impairment allowance.

The Group's definition of being credit-impaired is on a customer level, rather than on the level of an individual asset. According to the definition, a customer is credit-impaired when either of the following holds:
a) The Group assesses that it is unlikely that the customer can service all of their commitments to the Group in accordance with the terms of the agreements without recourse to default provisions in the agreements, or
b) The customer is more than 90 days past due on any of their commitments

The assessment in point a) is made based on a defined set of triggers, which includes serious breach of covenants, serious registrations on an internal watchlist, initiation of serious collection actions and serious external credit related information.

Furthermore, there is a defined set of conditions which must be satisfied so that customers that have been assessed as being credit-impaired are no longer subject to this assessment. This includes probation periods and a view to the future outlook of the customer.

Expected credit loss (ECL)

The ECL for each asset is calculated using models for the probability of a credit impairment event occurring (PD), the loss percentage expected in case of such an event (LGD) and the outstanding amount at the time of the event (EAD). In its simplest form the ECL can be calculated as the product of these factors, however, for several reasons, the actual formula must be more complicated than this.

The Group uses the standardised approach for regulatory capital purposes but has used PD models and LGD models for risk management purposes for several years. These models have been adapted for IFRS 9 purposes. For EAD, and for LGD to a certain extent, new models have been developed.

The PD models are either fully automated statistical models, expert models or hybrid. For the models with a component involving expert input there is a process in place to ensure proper review of the model outcome and periodic reassessment of obligors. The inputs into the models include demographic variables, information from financial statements and past payment behaviour, among other variables.

The effects of the economy on the PD is accounted for with the use of scaling factors which map through-the-cycle PD values to point-in-time PD values. The Group has a model to predict these scaling factors based on an economic forecast. The economic forecast is provided by the Group's Chief Economist. The forecast predicts a range of macroeconomic indicators over a horizon of five years. The model is applied to a subset of these indicators and produces a set of scaling factors. The scaling factors are then reviewed by the All Risk Committee with respect to all of the indicators and any other relevant information available and the committee approves their use for the calculation of the impairment. This process is carried out at least quarterly.

The Group uses three economic scenarios. In addition to the base forecast, scaling factors are produced for a bull and bear case. This is done in order to represent the whole range of possible future economic developments. The actual impairment allowance is the weighted average of the ECL in these different scenarios.

The All Risk Committee determined that it was appropriate to adjust the weights of the scenarios due to the COVID-19 pandemic, generally the scenarios are weighted 25%-50%-25% (good, base, bad) but it was determined appropriate to set the weights at 15%-55%-30%, as this would best represent the probability-weighted average over all possible scenarios.

67.4 Cont'd

The table below shows macroeconomic indicators of the Group's Chief Economist's macroeconomic forecast

Change in economic indicators %	2020	2021	2022	2023	2024
Economic growth	(8.6)	3.1	4.7	2.5	2.6
Housing prices in Iceland	2.6	1.5	3.0	4.0	4.0
Purchasing power	3.0	1.1	2.1	2.1	1.6
ISK exchange rate index	11.2	3.1	(1.8)	(2.8)	(1.5)
Policy rate, Central Bank of Iceland	1.5	1.2	2.0	3.0	3.5
Inflation	2.7	2.7	1.9	1.9	2.4
Capital formation	(10.2)	1.5	6.7	1.2	3.5
thereof capital formation in industry	(16.9)	(0.2)	8.7	3.5	3.0

The LGD model considers several scenarios for how a facility may develop once a credit event has occurred. One possibility is that the facility cures without a loss. If not, the recoveries may be based on the seizing of collateral and to estimate such recoveries, several scenarios for the development of the value of the collateral are considered. Finally, there may be recoveries even though a formal collateral is not in place. These different recovery scenarios are weighted differently depending on the economic scenario under consideration. This leads to a non-linear interaction and thus a difference between the probability weighted average ECL and the ECL in the most likely scenario.

For EAD it is necessary to account for expected prepayments on term loans and for the expected utilisation of commitments such as credit cards, overdrafts, financial guarantees and credit lines. The expected lifetime of agreements may also extend beyond the contractual lifetime for contracts which are generally extended.

Temporary changes have been made to the impairment model due to COVID-19 pandemic those changes are described in Note 3.

Write-off policy

When the Group has no reasonable expectations of recovering a credit exposure or when it is uneconomical to pursue legal collection, the financial asset is written off. A write-off does not change the debt obligation which is therefore still subject to enforcement activity. Any recoveries of amounts previously written off are credited to the income statement.

The impairment process

In the Group's impairment framework, the Stage assignment and ECL for each financial asset is calculated from the aforementioned models. The outcome is reviewed by the business units and they can propose changes if they provide sufficient supporting material. The impairment and any proposals for changes are reviewed by an Impairment Council appointed by the All Risk Committee and the impairment allowance is approved by the All Risk Committee on a quarterly basis.

The principle of materiality applies to the above discussion on impairment, whereby exceptions related to non-materiality and immaterial adjustments are not discussed.

67.5 Cash and cash equivalents

Cash and cash equivalents are carried at amortised cost in the statement of financial position and at the reporting date the expected credit loss is considered to be low. Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

Cash and cash equivalents in the statement of cash flows consist of cash on hand, balances with the Central Bank, demand deposits with credit institutions, and short-term loans to credit institutions. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition.

67.6 Derivative financial instruments

Derivatives are primarily used in trading activities but are also used to manage the Group's exposure to various risks, such as interest rate risk, inflation risk and currency risk. Derivatives are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities).

67.6 Cont'd

The Group applies hedge accounting. Accordingly, some of the Group's derivative financial assets and financial liabilities are accounted for as financial assets or financial liabilities mandatorily at fair value through profit or loss while others are accounted for as derivative assets or liabilities held for hedging (see Note 67.4 and Note 67.7).

When derivatives are embedded in other financial instruments or host contracts, such combinations are known as hybrid instruments with the effect that some of the cash flows of a hybrid instrument vary in a way similar to a stand-alone derivative. These embedded derivatives are measured and presented in the consolidated financial statements as if they were free-standing derivatives. The Group accounts for an embedded derivative separately from the host contract when, the host contract is not an asset in the scope of IFRS 9, is not carried at fair value through profit or loss, the terms of the embedded derivative would meet the definition of a derivative if they were contained in a separate contract, and the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract. When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

67.7 Hedge accounting

The Group elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting in accordance with IAS 39.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80-125%. In the assessment the Group assumes that the benchmark interest rate is not altered as result of the transition to alternative benchmark interest rates (see Note 4).

The Group applies fair value hedge accounting with respect to designated hedging relationships consisting of certain fixed-rate euro denominated bonds issued by the Group as the hedged items and certain euro denominated interest rate swaps as the hedging instruments, whereby the Group pays floating rate interest and receives fixed rate interest. The hedging relationships are designated and accounted for as fair value hedges because the interest rate swaps are hedging the exposure of the Group to changes in the fair value of the bonds arising from changes in interest rates. The Group recognises the changes in the fair value of the interest rate swaps immediately in profit or loss together with the changes in the fair value of the bonds which are attributable to the interest rate risk. The changes in the clean fair value of the swaps and the bonds are included in the line item “Net financial income (expense)”, the accrued interest on the bonds and the swaps is included in the line item “Interest expense” and foreign exchange gains and losses on the bond are included in the line item "Net foreign exchange gain (loss)".

If a hedging derivative expires or is sold, terminated or exercised, or a hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting for the corresponding hedging relationship is discontinued prospectively. Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

67.8 Property and equipment

Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses (see Note 67.19). Where parts of an item of property and equipment have different useful lives, those components are accounted for and depreciated as separate items of property and equipment.

Subsequent costs

The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred, if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in profit or loss as incurred.

67.8 Cont'd

Depreciation

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. The depreciable amount of each item of property and equipment is determined after deducting its residual value. Depreciation is recognised in profit or loss in the line item "Other operating expenses" on a straight-line basis over the estimated useful lives of each part of an item of property and equipment.

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

The estimated useful lives are as follows:

Buildings	50 years
Right-of-use-assets	1-11 years
Fixtures	6-12 years
Equipment	4-5 years
Vehicles	3 years

67.9 Intangible assets

Software

Software acquired by the Group is measured at cost less accumulated amortisation and impairment losses.

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs include all costs directly attributable to developing the software and capitalised borrowing costs. Internally developed software is carried at capitalised cost less accumulated amortisation and impairment losses.

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

Software is amortised on a straight-line basis over its estimated useful live from the date that it is available for use. The amortisation is recognised in profit or loss in the line item "Other operating expenses". The estimated useful life of software is four to ten years.

67.10 Leases

At the inception of a contract, the Group assesses whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. The Group has elected not to separate non-lease components and account for lease and non-lease components of a contract as a single lease component.

The Group as a lessee

The Group applies a single recognition and measurement approach for all leases, except for short-term leases and leases of low-value assets. The Group recognises a lease liability and a right-of-use asset at the lease commencement date. The Group has elected not to recognise right-of-use assets and lease liabilities for short-term leases that have a lease term of 12 months or less and leases of low-value assets. The Group recognises lease payments associated with these leases as an expense on a straight-line basis over the lease term.

Lease liabilities

The lease liability is initially measured at the present value of the lease payments, both fixed and variable, discounted using the entity's incremental borrowing rate. The incremental borrowing rate is the rate of interest the Group would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. The incremental borrowing rate is subject to estimation when no observable rates are available. The lease liability is measured at amortised cost using the effective interest method and remeasured when there is a change in future payments, e.g. arising from a change in an index or an assessment of whether extension or termination options will be exercised. After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced for the lease payments made.

67.10 Cont'd

The lease term is determined by the Group as the non-cancellable term of the lease, together with any periods covered by an option to extend the lease if it is reasonably certain to be exercised, or any periods covered by an option to terminate the lease, if it is reasonably certain not to be exercised. An assessment of whether the entity will exercise an extension or termination option is made by management annually. If the assessment of whether the Group will exercise an extension or termination option changes after the commencement date the lease liability is remeasured and a corresponding adjustment is made to the carrying amount of the right-of-use asset.

Right-of-use assets

The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred less any lease incentives received. For any remeasurement of the lease liability a corresponding adjustment is made to the carrying amount of the right-of-use asset or recorded in profit or loss if the carrying amount of the right-of-use asset has been reduced to zero. The right-of-use-asset is subsequently depreciated using the straight-line method from the commencement date to the end of the lease term. Right-of-use assets are subject to impairment.

If a lease modification increases the scope of the lease by adding a right to use of one or more underlying assets and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increased scope and any adjustments to the price that reflects the circumstances of the particular contract, then the modification is accounted for as a separate lease. For lease modifications that are not accounted for as separate leases the lease term of the modified lease is redetermined and the lease liability remeasured using the revised lease payments and discounted using the incremental borrowing rate at the effective date of modification. Any adjustment of the lease liability is then correspondingly made to the right-of-use asset.

The Group presents right-of-use assets in the line item "Property and equipment" and lease liabilities in the line item "Other liabilities" in the statement of financial position. Maturity analysis of lease liabilities is disclosed in Note 58. Interest on lease liabilities is recognised in profit or loss in the line item "Interest expense". Depreciation of right-of-use assets is recognised in profit or loss in the line item "Other operating expenses".

The Group as a lessor

The Group classifies leases based on the substance of the arrangements and the extent of the transfer of risks and rewards incidental to ownership of the leased asset. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

When the Group is the lessor in a capital lease, the Group recognises a receivable equal to the net investment in the lease and presents it in the line item "Loans to customers" in the statement of financial position. The Group applies its accounting policies for derecognition and impairment of financial assets also to its capital lease receivables. The Group recognises the finance income from capital lease receivables in profit or loss in the line item "Interest revenue" over the period of the capital lease so as to give a constant periodic rate of return on the net investment in the capital lease.

When the Group is a lessor in arrangements which involve the legal form of capital leases, but which in substance do not involve leases, the Group classifies them within loans at amortised cost.

67.11 Non-current assets and disposal groups held for sale

Non-current assets and disposal groups are either classified as held for sale when the Group expects to recover their carrying amount principally through a sale transaction rather than through continuing use or as held for distribution to owners when the Group is committed to distribute the asset, or disposal group, to the owners.

For this to be the case, the assets, or disposal groups, must be available for immediate sale, or distribution, in their present condition and their sale, or distribution, must be highly probable. The sale must only by subject to terms that are usual and customary for sales of such assets, or disposal groups.

Non-current assets and disposal groups are presented in a separate line in the statement of financial position but Non-current liabilities and disposal groups are presented in the line item "Other liabilities". Non-controlling interests in a disposal group are presented within equity.

Immediately before the initial classification as held for sale or distribution the assets, or components of disposal groups, are remeasured in accordance with applicable accounting policies. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell or costs to distribute.

Income and expenses of non-current assets and disposal groups held for sale are recognised in profit or loss in the line item "Discontinued operations, net of income tax" (see Note 67.21).

67.12 Loan commitments and financial guarantees

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. Expected credit loss of loan commitments (see Note 67.4) is recognised in the statement of financial position in the line item "Other liabilities". Loan commitment fees received by the Group are recognised in profit or loss in the line item "Fee and commission income".

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities.

Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received. Subsequently the liabilities are carried at the higher of the amount representing the initial fair value of the guarantee and the expected credit loss allowance of the guarantee (see Note 67.4). Any changes in the liabilities arising from financial guarantees are recognised in profit or loss. The premium received is recognised in profit or loss in the line item "Fee and commission income" over the life of the guarantee.

67.13 Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group will be required to settle the obligation with an outflow of resources, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the reporting date, taking into account the risks and uncertainties surrounding the obligation. When a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows.

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that the reimbursement will be received and the amount of the receivable can be measured reliably.

67.14 Employee benefits

All Group entities are required to pay, on a mandatory and contractual basis, contributions to public and private pension funds. The Group has no further payment obligations once these contributions have been paid. The Group recognises these contributions as salary related expenses when they become due. The Group does not have a defined benefit pension plan.

Short-term employee benefits include salaries, cash bonuses, non-monetary benefits and compensated absences. Short-term employee benefit obligations are expensed by the Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

67.15 Equity

Share capital

The share capital disclosed in the consolidated financial statements represents the total nominal value of ordinary shares issued by the Bank. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

Dividends on shares

Dividends payable to shareholders of the Bank are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders at the Bank's Annual General meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

Statutory reserve

According to the Act on Public Limited Companies no. 2/1995 the statutory reserve shall amount to 25% of the share capital of the Bank.

67.15 Cont'd

Restricted reserves

The Group is to transfer, if applicable, certain amounts from retained earnings to restricted reserves which can therefore not be distributed as dividends to shareholders. These restricted reserves are specified as follows:

Restricted reserve due to capitalised development costs

When the Group capitalises development cost it transfers a corresponding amount from retained earnings to a restricted reserve. In the future the restricted amount is to be transferred back to retained earnings as the capitalised development cost is amortised in profit or loss.

Restricted reserve due to fair value changes of financial assets

The Group transfers fair value changes of financial assets at fair value through profit or loss, net of tax if applicable, from retained earnings to a restricted reserve. Amounts recognised in the reserve are transferred back to retained earnings upon sale of the financial asset.

Restricted reserve due to unrealised profit of associates

If share of profit of an associated company is in excess of dividend received or which can be claimed, the Group transfers the difference to a restricted reserve in equity. If the Group's shareholding in an associate is sold or written off the applicable amount recognised in the reserve is transferred to retained earnings.

Fair value reserve

Fair value reserve comprises all unrealised gains or losses related to fair value changes of equity instruments classified at fair value through other comprehensive income. On derecognition of the equity instruments fair value changes are not reclassified to profit and loss.

Liability credit reserve

Changes in fair value attributable to changes in the credit risk of financial liabilities designated as at fair value through profit or loss are recognised in liability credit reserve. On derecognition the fair value changes are not reclassified to profit or loss.

Translation reserve

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

67.16 Interest income and interest expense

For all financial assets and financial liabilities measured at amortised cost, interest income and interest expense are recognised in profit or loss using the effective interest method.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate. The change in carrying amount is recorded as interest income or interest expense. For floating rate instruments, interest income or interest expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset. For financial assets in Stage 1 and Stage 2 interest is recognised on the gross carrying amount of the assets and for financial assets in Stage 3 interest is recognised on the gross carrying amount of the assets, net of impairment allowance (see Note 67.4).

Interest income and interest expense include gains and losses on derecognition of financial assets and financial liabilities measured at amortised cost.

For financial assets and financial liabilities at fair value through profit and loss, interest income and interest expense are recognised through profit or loss on an accrual basis, except for financial liabilities at fair value through profit or loss (see Note 67.4).

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro denominated bonds issued by the Group (see Note 67.7), is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

67.17 Net fee and commission income

Fees and commissions are recognised to reflect the transfer of services to customers at an amount that reflects the consideration that is expected to be received for such services. Fee and commission income and expenses that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Fees for loan commitments that are likely to be utilised are recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to be utilised, fees are recognised in profit or loss on a straight-line basis over the commitment period.

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities, or the purchase or sale of businesses, are recognised on completion of the underlying transaction.

Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportioned basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria are fulfilled.

Where it is assessed that the Group is acting as an agent, the consideration is presented on a net basis.

67.18 Net financial income (expense)

Net financial income (expense) consists of net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss, net gain (loss) on financial liabilities designated as at fair value through profit or loss and net gain (loss) on fair value hedges.

Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss
Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets and financial liabilities classified by the Group as mandatorily at fair value through profit or loss, except for interest income and interest expense, which are included in the line items "Interest income" and "Interest expense", and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)". Dividend income from financial assets is recognised in the income statement when the Group's right to receive payment is established.

Net gain (loss) on financial liabilities designated as at fair value through profit or loss
Net gain (loss) on financial liabilities designated as at fair value through profit or loss includes all realised and unrealised fair value changes of financial liabilities designated by the Group as at fair value through profit or loss, except for changes in fair value attributable to changes in credit risk which is recognised in other comprehensive income, interests incurred which are included in the line item "Interest expense", and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Net gain (loss) on fair value hedges
Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are accounted for as hedging instruments in fair value hedges and the changes in the fair value of certain bonds, which are attributable to the interest rate risk of the bonds, and are accounted for as the hedged items in fair value hedges (see Note 67.7).

67.19 Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than deferred tax assets and non-current assets and disposal groups held for sale, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the Group estimates the recoverable amount of the asset. If the carrying amount of an asset exceeds its estimated recoverable amount an impairment loss is recognised in profit or loss.

An impairment loss for non-financial assets is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

67.20 Taxes

Income tax expense

Income tax expense comprises special financial activities tax, current tax and deferred tax and is disclosed as a separate line item in the income statement. Income tax expense from discontinued operations is included in the income statement in the line item "Discontinued operations, net of income tax" (see Note 67.21). Income tax is recognised in profit or loss, except to the extent that it relates to items recognised directly in equity, consistent with the recognition of the underlying item to which it relates.

Bank tax

Bank tax is calculated as 0.145% (2019: 0.376%) of total liabilities at year-end as determined for tax purposes, in excess of ISK 50,000 million, excluding tax liabilities. The Bank tax is considered a non-deductible expense for the calculation of income tax. The Bank tax is shown in a separate line in the income statement and is included in the statement of financial position in the line item "Tax liabilities".

Special financial activities tax

Special financial activities tax is calculated as 6% of taxable profit exceeding ISK 1,000 million. Special financial activities tax is included in the statement of financial position in the line item "Tax liabilities".

Current tax

Current tax is the expected tax payable on the taxable income for the year using tax rates enacted at the reporting date. Current tax also includes any adjustment to tax payable in respect of previous years. Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Current tax is included in the statement of financial position in the line item "Tax liabilities".

Deferred tax

Deferred tax is recognised based on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts. However, deferred taxes are not recognised if it arises from the initial recognition of an asset or liability, in a transaction other than a business combination, that at the time of the transaction affects neither the taxable profit nor the accounting profit. In addition, deferred taxes are not recognised if the temporary difference arises from the initial recognition of goodwill.

Deferred tax is measured using tax rates enacted at the reporting date.

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

Deferred tax liabilities are included in the statement of financial position in the line item "Tax liabilities" and deferred tax assets are included in the statement of financial position in the line item "Other assets". Deferred taxes that are part of discontinued operations (see Note 67.11) are included in the line items "Non-current assets and disposal groups held for sale" and "Other liabilities", respectively, in the statement of financial position.

67.21 Discontinued operations, net of income tax

Discontinued operations, net of income tax, are disclosed as a separate line item in the income statement and consist of (i) profit or loss from foreclosed assets and disposal groups held for sale, (ii) gain or loss recognised on the measurement to fair value less costs to sell in excess of book value of foreclosed assets, (iii) profit or loss from sales of foreclosed assets and disposal groups held for sale, and (iv) income tax expense from discontinued operations.

67.22 Offsetting

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

The Group presents income and expenses on a net basis in the income statement only when required or permitted by the accounting standards.

67.23 Earnings per share

The Group presents basic and diluted earnings per share for its ordinary shares. Basic earnings per share are calculated by dividing the profit or loss attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period. Diluted earnings per share are determined by adjusting the profit or loss attributable to ordinary shareholders of the Bank and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

Íslandsbanki

Consolidated Financial Statements 2019

The audited consolidated financial statements of Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) for the year 2019 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Group".

Operations in 2019

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share. The vision is to make Íslandsbanki #1 for service.

The profit from the Group's operations for the reporting period amounted to ISK 8,454 million, which corresponds to 4.8% return on equity. The Board of Directors proposes that ISK 4.2 billion will be paid in dividends to shareholders, which is in line with the Bank’s policy of paying dividends of 40-50% of profit of the year. The Board may convene a special shareholders' meeting later in the year to propose payment of additional dividends if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements. In 2019, the Bank paid ISK 5.3 billion in dividends to the Bank's shareholders, amounting to 50% of the Bank’s profit of the year in 2018. At the end of the reporting period, the Group employed 984 full-time members of staff, including 749 within the Bank itself, 60% female and 40% male.

Net interest income increased by 5.4% between years, broadly in line with growth in the loan book. Net fee and commission income increased by 9.3%, as modest growth in the Bank was supported by strong growth in the Bank’s three main subsidiaries. Other net operating income was ISK 1.5 billion, where negative net financial income was offset by one-off items in other operating income. The one-off items were a settlement of the Bank’s claim deriving from the acquisition of Byr savings bank in 2011 and a reversal of previously expensed contribution to the Depositors' and Investors' Guarantee Fund relating to past changes in the legislation on deposit insurance. Administrative expenses were up by 1.7% between years. Salary costs were up by 5.0% due to general wage increases and substantial redundancy payments, offset by reduction in the number of FTE's in the Bank where the number of year-end employees reduced by 10.2% between years. Net impairments were negative by ISK 3.7 billion, going from a net reversal of ISK 1.6bn in 2018 to a net charge in 2019, adversely affected by adjustments made to take into account the increased downside risk in the macroeconomic outlook and increased impairments against a few single-name exposures.

The balance sheet of the Group grew by 6.1% between years on the back of a 6.3% growth in loans to customers, with the largest increase in Personal banking. Loan book growth was especially strong in the first half of the year and slowed somewhat down in the second half and especially in the fourth quarter. The ratio of non-performing loans rose from 1.7% to 3.0% during the year due to a less favourable economic environment, with economic growth close to zero percent due to a drop in tourism.

Deposits from customers increased by 6.8% in 2019, driven by an increase in deposits from individuals and institutional investors. The Bank issued its first senior unsecured bond in the domestic market in 2019 and the issuance was well received by investors in Iceland and will serve as a good benchmark for other banks and corporate issuers. The Bank continued to have good access to international capital markets and fulfilled its funding plans across markets. In the second quarter the Bank issued a Tier 2 bond in the Nordic market and continues to be well supported by investors in that region. In January the Bank terminated its credit rating contract with Fitch ratings and was the decision driven primarily from a cost perspective. The Bank's ratings were affirmed by S&P (BBB+), however S&P placed all the Icelandic banks on negative outlook, mainly due to weaker earnings and competition from the pension funds in the mortgage market.

The Group's total equity amounted to ISK 180.1 billion and total assets were ISK 1,199.5 billion at the end of the reporting period and the Group's total capital ratio was 22.4%. At the end of September, the Group was presented with the results of the annual SREP process conducted by the Icelandic Financial Supervisory Authority. The results included the updated capital requirement for the Group. The total regulatory capital requirement is now 18.8% of the risk exposure amount and did not change from the last SREP process. The composition of the requirement did however change, as a 50 basis point increase in the counter-cyclical buffer was offset by a reduction in the pillar 2 charge. The countercyclical buffer will increase by further 25 basis points, from 1.75% to 2.00%, as of February 2020, which will then bring the total regulatory capital requirement up to 19.0%. The Bank’s capital target entails a management buffer of 0.5-2.0% on top of the SREP requirement and from February 2020 onwards the capital target will therefore be 19.5-21.0%. The Bank's liquidity position remains strong and well above regulatory requirements.

The Bank engaged BCG Nordics to help to formulate a new strategy for the Bank and the outcome was presented to the Bank's employees at a strategic summit at the end of March. The strategy work was based on extensive research, industry insights and benchmarks, identifying the competitive advantages and future strategic positioning in a changing environment. The outcome of the work was an articulation of the Bank's purpose, values and vision along with a list of strategic initiatives to be implemented in the next five years. The purpose of “Moving Iceland forward through empowering our customers to succeed” was defined through input from workshops with all employees. It articulates a more active role of the Bank in a shaping and progressing society. The purpose is further supported by three values that will serve as a guiding principle for employees in all their efforts: 'Passion, Professionalism, and Collaboration'.

To live the purpose and values, Íslandsbanki continues to be guided by the vision to be '#1 for service', placing the customer at the centre of gravity for value creation. The Bank will put a strong emphasis on technology to facilitate innovation and development of simple, efficient solutions for its customers. Going forward, the Bank will be reinforcing its commitment to corporate social responsibility (CSR) by integrating social and environmental impact as a driver of strategy and value creation within the Bank. As such, the Bank's CSR work will be centred around four of the United Nations’ seventeen Sustainable Development Goals (SDGs): #4 Quality education; #5 Gender equality; #9 Industry, innovation and infrastructure; and #13 Climate action. As a result of the BCG work, the Bank has also focused on improving its pricing models and finding efficiency gains, for example with the implementation of robotics.

Outlook

Following a long period of robust growth, the Icelandic economy faced headwinds in 2019 as a major airline went bankrupt and the number of tourists visiting the country declined by 14% year-on-year. However, the tourist sector, as well as the wider economy, seems to be weathering this setback relatively well so far. The improvement in the balance sheets of both the private and public sector over the past decade are a major factor in increasing economic resilience to adverse developments such as those Iceland has faced recently.

The Bank's Chief economist expects GDP growth to resume in 2020, following broadly unchanged GDP in 2019, measuring 1.4% this year and rising to 2.3% in 2021. After a year of contraction, investment is assumed to return to growth as business sentiment recovers and the public sector steps up infrastructure investments. Buoyed by a sound financial position and ongoing real wage growth, households are expected to continue increasing private consumption, albeit at a more modest pace than in recent years. Inflation has subsided to the Central Bank's target after a short-lived inflation spike and the outlook is for moderate inflation in coming quarters, which will increase the leeway for counter-cyclical economic policy. The Icelandic króna has remained relatively stable following a 10% depreciation in the latter half of 2018 and there are numerous indications that the current exchange rate will help facilitate a continuation of the historically long period of current account surplus Iceland has enjoyed in recent years.

The Bank aims to reach a return of equity of 8-10%. To achieve that goal, the Bank will strive to continue to grow revenue on average in line with GDP, while growing the cost base at a slower pace with strict cost control and efficiency gains, lowering the cost-income ratio below our target of 55%. The Bank’s capital position remains strong and well above the regulatory requirements, supporting dividend payments in line with the target of 40-50% payout ratio.

Risk management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations and the Bank has focused on building up a responsible internal risk culture among the Bank's employees. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies and the CEO is responsible for ensuring that risks are managed within those limits.

The Board hereby declares that Íslandsbanki has overall satisfactory risk management in relation to the Bank’s profile and strategy.

The Bank's risk management framework and policies are discussed under Notes 45-63 to the consolidated financial statements and in the unaudited Pillar 3 Report.

Ownership

The Bank is wholly owned by the Icelandic Government and there were no changes in the ownership during the course of 2019. The shares are administered by the Icelandic State Financial Investments (ISFI) in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Icelandic Government published in July 2017 a general ownership policy for financial institutions with regards to ownership stakes administered with the Icelandic State Financial Investments (ISFI). In December 2018 the Bank signed an agreement with ISFI on general and specific goals for the operations, in line with article 2.3 in the policy.

Corporate governance

The Board of Directors of Íslandsbanki is committed to excellence in its governance framework so that it complies with the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as “Exemplary in Corporate Governance” in March 2014 by the Center of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition has been renewed annually since.

The Board of Directors comprises seven non-executive directors and two alternates. The Board undertakes the Bank's affairs and is responsible for setting the Bank's general strategy as well as instructing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with relevant laws, regulations and good business practices. Furthermore, the Board shall monitor the execution of its policies, the sound control of accounting and financial management, and ensure that group internal audit, compliance, risk management and internal controls are effective at all times.

Candidates for board membership are nominated through a selection process administered by the Icelandic State Financial Investments in accordance with Article 7 of the ISFI Act no. 88/2009. At the Bank's Annual General Meeting in March the Board of Directors was elected for the Bank. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board consists of seven members, three female and four male. The Board has approved a policy on the suitability of the Board of Directors, the CEO and key function holders. The policy states, among other things, that the composition of the Board shall at any time be diverse, with regard to educational and professional background, gender and age.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of Board subcommittees are available on the Bank's website.

The CEO is responsible for the day-to-day operations of the Bank and that the Bank's business is, at all times, in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Committee and other Senior Management Committees.

The Executive Committee, comprising seven members, including the CEO, is composed of three women and four men. The role of the Executive Committee is to maintain an overall view of the Bank's operations and to coordinate key aspects of its activities that are not supervised by other senior management committees. The CEO ensures that the Board is regularly provided with accurate information on the Bank's finances, development and operations.

The Bank's Finance division is responsible for the preparation of the Group's consolidated financial statements which are prepared in accordance with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review the second quarter interim consolidated financial statements and audit annual consolidated financial statements.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to its operations, including those imposed by the FME, Central Bank of Iceland and Nasdaq Iceland. The applicable laws include, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Public Limited Companies no. 2/1995 and the Act on Competition no. 44/2005, available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is (hereinafter the Guidelines). The Bank's practices are compliant with the guidelines except for Article 1.5.

Article 1.5 of the Guidelines provides that the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by ISFI in accordance with article 7 of the ISFI Act.

A more detailed description of Íslandsbanki's governance framework and associated practices can be found in the Bank's Corporate Governance Statement enclosed in an unaudited Appendix to the consolidated financial statements and on the Bank's website, www.islandsbanki.is.

Sustainability

Íslandsbanki's Sustainability Policy was approved by its board in late 2019. The Policy aims at making the Bank a model of exemplary operations in the Icelandic business community, based on internationally recognised environmental, social, and governance (ESG) criteria. The ESG criteria are a set of references used by investors to evaluate investments based on responsible investment methodology.
The Bank aims to be a leader in the area of sustainable development and a catalyst for positive social action, moving Iceland forward by empowering its customers to succeed. To this end, the Bank intends to initiate broad collaboration on responsible business practices that both contribute to sustainable development in the Icelandic economy and support the Government's Climate Action Plan, while also supporting the UN SDGs.

Alongside its vision of being a leader in service to customers, the Bank will focus on integrating sustainability considerations into its activities, in addition to its profit objectives. The Bank will take account of ESG criteria in its risk management and will explore opportunities to take advantage of green investment opportunities. Íslandsbanki aims to increase the general public's financial knowledge and interest in the subject and, to this end, it offers interesting and accessible seminars on finance and economics.

Íslandsbanki's Sustainability Policy creates a comprehensive framework for its activities in the area of environmental affairs, respect for human rights, responsible lending, investments, purchasing, and grants, as well as integrating with and supporting the Bank's other policies. Íslandsbanki sets quantifiable ESG targets in its operations and discloses its performance relative to targets in a separate report issued concurrent with the Bank's annual financial statements.

As a signatory to the UN Global compact Íslandsbanki is committed to aligning its operations and strategies with 10 principles covering human rights, labour, the environment and anti-corruption. The Bank has in place a Code of Conduct and a Conflict of Interest Policy in order to ensure creditability in business transacted by the Bank and its clients and employees' impartiality in handling and processing individual cases.

The Bank's sustainability and ESG factors are further described in the unaudited annual and sustainability report.

Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2019 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable, to the extent that they are not inconsistent with the requirements of the IFRS as adopted by the EU.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2019 and its financial position as of 31 December 2019. Furthermore in our opinion the financial statements and the Director's report give fair view of the main operational developments and achievements and describe the principal risks and uncertainties that the Group faces in its operations.

The Board of Directors and the CEO have today discussed and approved the 2019 Consolidated Financial Statements of Íslandsbanki.

Kópavogur, 12 February 2020

Board of Directors:

Friðrik Sophusson, Chairman
Tómas Már Sigurðsson, Vice-Chairman
Anna Þórðardóttir
Auður Finnbogadóttir
Árni Stefánsson
Hallgrímur Snorrason
Heiðrún Jónsdóttir

Chief Executive Officer:

Birna Einarsdóttir

Independent Auditor's Report

To the Board of Directors and shareholders of Íslandsbanki hf.

Opinion

We have audited the consolidated financial statements of Íslandsbanki hf. and its subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2019 and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2019, and its consolidated financial performance and its consolidated cash flows for the year then ended, in accordance with the International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

Basis for Opinion

We conducted our audit in accordance with the International Standards on Auditing (ISAs). Our responsibilities are further described in the Auditor's Responsibilities for the Audit of the financial statements section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the consolidated financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key Audit Matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Why significant	How our audit addressed the Key Audit Matter
Provision for credit impairment	

As described in Notes 2 and 66.3, the provision for credit impairment is determined in accordance with International Financial Reporting Standard 9, Financial Instruments (IFRS 9).
 	
The provision for credit impairment is dependent on the estimation and judgement of management. Loans to customers represent ISK 899,632 million or 75% of total assets at 31 December 2019 against which impairment allowances of ISK 10,298 million have been recorded.
 	
Key areas of judgement include:
- the interpretation of the requirements to determine impairment under application of IFRS 9, which is reflected in the Group's expected credit loss model;
- the identification of loans with significant deterioration in credit quality;
- assumptions used in the expected credit loss model such as the financial condition of the counterparty, expected future cash flows and forward-looking macroeconomic factors as disclosed in Notes 2 and 66.3.
 	
The determination of the provision for credit impairment is based on estimates and judgement by management. Due to the use of judgement and estimates and the relative size of loans to customers on the balance sheet, we consider the provision for credit impairment a Key Audit Matter.
	Our procedures focused on the following to respond to the Key Audit Matter, among others:
	
	- Assessing the Group's expected credit loss model, focusing on the following areas:
	  - alignment of the expected credit loss model and its underlying methodology with the requirements of IFRS 9; and
	  - approach to the incorporation of forward-looking macroeconomic factors.
	- Testing the effectiveness of relevant controls relating, among others, to the:
	  - data used to determine the provision for credit impairment, including transactional data captured at loan origination and ongoing internal credit quality assessment;
	  - expected credit loss model, including model build and approval, ongoing monitoring/validation, model governance and mathematical accuracy;
	  - registration and valuation of collateral used in the calculation of expected credit loss;
	- Examination of a sample of loans and procedures to evaluate the:
	  - timely identification of loans with significant deterioration in credit quality; and
	  - expected loss calculation by re-performing and assessing the reasonableness of the ECL model calculations.
	
	In addition, we assessed the adequacy of the disclosures in the consolidated financial statements.

Why significant	How our audit addressed the Key Audit Matter
Reliability of information from IT systems	
The Group is highly dependent on IT systems due to the significant number of transactions that are processed daily and the complexity of the various systems used by the Group. In the process of preparing the consolidated financial statements the Group uses information from many systems and is dependent on the accuracy and completeness of information drawn from the systems. Because of the above we consider the accuracy and completeness of information generated by the IT systems a Key Audit Matter.	Our procedures focused on the following, among other, to respond t the Key Audit Matter: We selected the systems most important for the preparation of the consolidated financial statements. For those, the following procedures among others, were performed: ▸ Inspection of the appropriateness of employees' access. ▸ Recalculation of interest income and expense calculations in the systems for selected dates during the year. ▸ Comparison of information from the systems with external data sources, such as currency exchange rates and consumer price index. ▸ Comparison of information from different systems within the group for consistency. ▸ Recalculation of reports generated by the systems. ▸ Testing of IT application controls For a material outsourced system, we relied on an ISAE 3402 report provided by the service provider.

We have fulfilled our responsibilities described in the "Auditor´s responsibilities for the audit of the consolidated financial statements" section, including in relation to the Key Audit Matters above. Accordingly, our audit included the design and performance of procedures to respond to our assessment of the risks of material misstatement of the consolidated financial statements. The results of our audit procedures, including the procedures performed to address the matters above, provide the basis for our audit opinion on the consolidated financial statements.

Other information

This document also contains other information than the consolidated financial statements and our auditor's report thereon. The other information are: The unaudited highlights, Directors´ Report, unaudited quarterly statements in note 9 and unaudited Íslandsbanki ´s Corporate Governance Statement 2019 in appendix. Management and Board of Directors are responsible for the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon except for confirmation regarding Directors´ Report as stated below.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether it is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If we, based on the work we have performed concerning this other information, conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of CEO and Board of Directors for the consolidated financial statements

The Chief Executive Officer (CEO) and Board of Directors are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

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

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors is responsible for overseeing the Group's consolidated financial reporting process.

Auditor's Responsibilities for the Audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with the International Standards on Auditing (ISAs), we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the Key Audit Matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on the Board of Directors Report

Pursuant to the legal requirements of Article 104, Paragraph 2 of the Icelandic Financial Statement Act no. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the consolidated financial statements includes all information required by the Icelandic Financial Statement Act.

Reykjavík, 12 February 2020

Margrét Pétursdóttir
State Authorised Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Consolidated Income Statement

	Notes	2019	2018
Interest income*		62,846	61,675
Interest expense		(29,170)	(29,738)
Net interest income	10	33,676	31,937
Fee and commission income		21,026	19,853
Fee and commission expense		(7,667)	(7,626)
Net fee and commission income	11	13,359	12,227
Net financial expense	12	(817)	(962)
Net foreign exchange gain	13	143	1
Other operating income	14	2,134	1,784
Other net operating income		1,460	823
Total operating income		48,495	44,987
Salaries and related expenses	15	(16,279)	(15,500)
Other operating expenses	16	(11,828)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund		(936)	(1,173)
Bank tax	66.22	(3,528)	(3,281)
Total operating expenses		(32,571)	(32,104)
Profit before net impairment on financial assets		15,924	12,883
Net impairment on financial assets	18	(3,663)	1,584
Profit before tax		12,261	14,467
Income tax expense	19	(3,682)	(4,734)
Profit for the year from continuing operations		8,579	9,733
Discontinued operations, net of income tax	20	(125)	912
Profit for the year		8,454	10,645

*Of which interest income amounting to ISK 60,123 million (2018: ISK 59,741 million) is calculated using the effective interest method.

	Notes	2019	2018
Profit attributable to:			
Shareholders of Íslandsbanki hf.		8,809	11,036
Non-controlling interests		(355)	(391)
Profit for the year		8,454	10,645
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	21	0.89	1.01

The notes on pages 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 10 Amounts are in ISK million

Consolidated Statement of Comprehensive Income

	2019	2018
Profit for the year	8,454	10,645
Items that will not be reclassified to profit or loss		
Changes in fair value of financial assets, net of tax	1,272	610
Changes in fair value of financial liabilities, net of tax	(677)	1,120
Other comprehensive income for the year, net of tax	595	1,730
Total comprehensive income for the year	9,049	12,375

Total comprehensive income attributable to:		
Shareholders of Íslandsbanki hf.	8,939	12,542
Non-controlling interests	110	(167)
Total comprehensive income for the year	9,049	12,375

The notes on pages 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 11 Amounts are in ISK million

Consolidated Statement of Financial Position

	Notes	31.12.2019	31.12.2018
Assets			
Cash and balances with Central Bank	22	146,638	135,056
Loans to credit institutions	23	54,376	41,577
Bonds and debt instruments	5	52,870	69,415
Derivatives	24	5,621	4,550
Loans to customers	25	899,632	846,599
Shares and equity instruments	5	18,426	13,074
Investments in associates	27	746	682
Property and equipment	29	9,168	5,271
Intangible assets	30	4,330	5,002
Other assets	31	7,683	9,177
Total Assets		1,199,490	1,130,403
Liabilities			
Deposits from Central Bank and credit institutions	32	30,925	15,619
Deposits from customers	33	618,313	578,959
Derivative instruments and short positions	24	6,219	5,521
Debt issued and other borrowed funds	35	306,381	300,976
Subordinated loans	36	22,674	16,216
Tax liabilities	38	7,853	7,150
Other liabilities	39	27,063	29,649
Total Liabilities		1,019,428	954,090
Equity			
Share capital		10,000	10,000
Share premium		55,000	55,000
Reserves		7,065	6,499
Retained earnings		105,569	102,496
Total Shareholders' Equity		177,634	173,995
Non-controlling interests		2,428	2,318
Total Equity		180,062	176,313
Total Liabilities and Equity		1,199,490	1,130,403

The notes on pages 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 12 Amounts are in ISK million

Consolidated Statement of Changes in Equity

	Share capital	Share premium	Statutory reserve	Restricted reserves	Fair value reserve	Liability credit reserve	Retained earnings	Total shareholders' equity	Non-controlling interests	Total equity
Equity as at 1.1.2019	10,000	55,000	2,500	3,750	625	(376)	102,496	173,995	2,318	176,313
Profit (loss) for the year							8,809	8,809	(355)	8,454
Dividends paid							(5,300)	(5,300)		(5,300)
Net change in fair value of financial assets					807			807	465	1,272
Net change in fair value of financial liabilities						(16)	(661)	(677)		(677)
Restricted due to capitalised development costs				(551)			551	-		-
Restricted due to fair value changes				308			(308)	-		-
Restricted due to subsidiaries and associates				18			(18)	-		-
Equity as at 31.12.2019	10,000	55,000	2,500	3,525	1,432	(392)	105,569	177,634	2,428	180,062
Equity as at 1.1.2018	10,000	55,000	2,500	3,440	239	(1,486)	104,760	174,453	2,485	176,938
Profit (loss) for the year							11,036	11,036	(391)	10,645
Dividends paid							(13,000)	(13,000)		(13,000)
Net change in fair value of financial assets					386			386	224	610
Net change in fair value of financial liabilities						1,110	10	1,120		1,120
Restricted due to capitalised development costs				458			(458)	-		-
Restricted due to fair value changes				123			(123)	-		-
Restricted due to subsidiaries and associates				(271)			271	-		-
Equity as at 31.12.2018	10,000	55,000	2,500	3,750	625	(376)	102,496	173,995	2,318	176,313

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2019 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank. The Bank has one class of ordinary shares which carry no right to fixed income. The Annual General Meeting ("AGM") for the operating year 2018 was held on 21 March 2019. At the AGM shareholders approved the Board's proposal to pay dividends to shareholders amounting to ISK 5,300 million which is equivalent to ISK 0.53 per share (2018: ISK 1.30 per share). The dividends were paid on 27 March 2019.

The notes on pages 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 13 Amounts are in ISK million

Consolidated Statement of Cash Flows

	Notes	2019	2018
Profit for the year		8,454	10,645
Non-cash items included in profit for the year*		24,324	16,061
Changes in operating assets and liabilities*		(7,998)	(120,407)
Dividends received		46	55
Income tax and bank tax paid		(6,493)	(7,873)
Net cash provided by (used in) operating activities		18,333	(101,519)
Net investment in subsidiaries and associated companies		-	4,764
Proceeds from sales of property and equipment		21	15
Purchase of property and equipment		(327)	(611)
Purchase of intangible assets		(246)	(877)
Net cash (used in) provided by investing activities		(552)	3,291
Proceeds from borrowings		112,105	115,661
Repayment of borrowings		(114,708)	(48,475)
Repayment of lease liabilities		(378)	-
Dividends paid		(5,300)	(13,000)
Net cash (used in) provided by financing activities		(8,281)	54,186
Net increase (decrease) in cash and cash equivalents		9,500	(44,042)
Effects of foreign exchange rate changes		(222)	(193)
Cash and cash equivalents at the beginning of the year		143,203	187,438
Cash and cash equivalents at year-end		152,481	143,203

Reconciliation of cash and cash equivalents			
Cash on hand	22	4,403	3,095
Cash balances with Central Bank	22	142,235	131,961
Bank accounts	23	21,122	25,259
Mandatory reserve and special restricted balances with Central Bank	22	(15,279)	(17,112)
Cash and cash equivalents at year-end		152,481	143,203

*For further breakdown see the following page.

The Group has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year.

Interest received in 2019 amounted to ISK 60,624 million (2018: ISK 58,354 million) and interest paid in 2019 amounted to ISK 22,736 million (2018: ISK 24,386 million). Interest paid 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 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 14 Amounts are in ISK million

Consolidated Statement of Cash Flows

	2019	2018
Depreciation, amortisation and write-offs	1,960	1,312
Share of profit of associates	(64)	(29)
Accrued interest and fair value changes on debt issued and subordinated loans	11,450	10,436
Net impairment on financial assets	3,568	(1,634)
Foreign exchange gain	(143)	(1)
Net loss (gain) from sales of subsidiaries, property and equipment	17	(1,557)
Unrealised fair value loss recognised in profit or loss	192	406
Discontinued operations, net of income tax	125	(912)
Bank tax	3,528	3,281
Income tax	3,682	4,734
Other changes	9	25
Non-cash items included in profit for the year	24,324	16,061

	2019	2018
Mandatory reserve and special restricted balances with Central Bank	1,833	454
Loans to credit institutions	(15,268)	767
Bonds and debt instruments	17,254	(38,740)
Loans to customers	(52,638)	(82,808)
Shares and equity instruments	(3,953)	(2,411)
Other assets	1,653	3,455
Deposits from Central Bank and credit institutions	15,232	4,116
Deposits from customers	37,678	4,307
Derivative instruments and short positions	(2,944)	(2,761)
Other liabilities	(6,845)	(6,786)
Changes in operating assets and liabilities	(7,998)	(120,407)

Non-cash transactions 2019
During the year the Bank repurchased own debt securities amounting to ISK 4,319 million by issuing new debt.

The Group recognised right-of-use assets amounting to ISK 4,505 million and the same amount in lease liabilities following the adoption of IFRS 16 - Leases (see Note 3).

Non-cash transactions 2018
During the year the Bank repurchased own debt securities amounting to ISK 184 million by issuing new debt.

The notes on pages 16 to 84 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2019 15 Amounts are in ISK million

Notes to the Consolidated Financial Statements

1. Corporate information

Íslandsbanki hf., the parent company, was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The consolidated financial statements for the year ended 31 December 2019 ("the consolidated financial statements") comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

At the end of 2019 the Bank was wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Group provides a wide range of financial services such as retail banking, corporate banking, investment banking, wealth management and asset financing. The Group operates mainly in the Icelandic market.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 12 February 2020.

2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The consolidated financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At year-end 2019 the exchange rate of the ISK against the USD was 121.10 and 135.83 for the EUR (year-end 2018: USD 116.33 and EUR 133.23).

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, the consolidated financial statements have been prepared on a going concern basis.

Significant accounting estimates and judgements

The preparation of the 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. Actual results may differ from those estimates.

Estimates and underlying assumptions are regularly review and revised by management as deemed necessary. Changes in accounting estimates are recognised when they occur.

Impairment of financial assets

The main assumptions used for calculating the allowance for credit losses that are subject to significant judgement include the following:

• Probability of default (PD), loss given default (LGD) and exposure at default (EAD)

• Macroeconomic variables for multiple scenarios build on available information

• Assessment of significant increase in credit risk

The probability of default (PD), exposure at default (EAD), and loss given default (LGD) inputs used to estimate expected credit losses are modelled based on variables that are most closely related with credit losses in the relevant portfolio. This includes macroeconomic variables, demographic variables, variables related to past payment history among other variables. These variables are sourced both internally and externally. Significant judgements required for measuring expected credit loss (ECL) include the following:

- Determining criteria for assessing what constitutes a significant increase in credit risk
- Establishing the forward-looking scenarios and their relative weightings
- Choosing appropriate models and assumptions for the measurement of ECL

The allowance for credit losses is further discussed in Notes 25-26, in Notes 48-50 on risk management and in Note 66.3.

Fair value of financial instruments

The fair value of financial instruments where an active market or quoted prices are not available are decided upon by using estimation procedures. Financial instruments measured at fair value are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. Level 3 financial assets are measured at fair value using valuation techniques based on significant unobservable inputs. The valuation of Level 3 financial assets is subjective as the assumptions on which the valuation is based on are not easily observable and subject to management's assessment. The valuation techniques are discussed in Notes 6-7 and in Note 66.3.

2. Cont'd

Intangible assets

Intangible assets, except for goodwill, are amortised over four to ten years. Intangible assets are reviewed at each reporting date to determine whether there is any indication of impairment. The value in use method is used by the Group to determine the recoverable amount of intangible assets. The following relevant criteria are considered when assessing whether indications of impairment exists:

- A decline in the asset´s market value
- Plans to restructure or liquidate the asset
- The asset generates less income than anticipated

Intangible assets are further discussed in Note 30 and in Note 66.9.

3. Changes to accounting policies

The Group adopted a new IFRS standard, IFRS 16 – Leases, which replaced IAS 17, IFRIC 4, SIC 15 and SIC 27 as of 1 January 2019. The standard sets out the principles for the recognition, measurement, presentation and disclosure of leases and requires lessees to account for most leases under a single on-balance sheet model. As a result of the adoption of IFRS 16, the Group has changed its accounting policy for lease contracts (see Note 66.10).

A number of amendments to IFRS standards were effective from 1 January 2019 but they did not have a material impact on the Group's consolidated financial statements.

Impact of adoption of IFRS 16

The Group applied IFRS 16 using the modified retrospective approach and therefore the comparative information has not been restated.

The Group's lease liabilities and right-of-use assets at transition were mostly derived from CPI-linked lease commitments for offices, branches and storage but a small minority stems from lease commitments for land. At transition, ISK 4,505 million were recognised as lease liabilities and the same amount as right-of-use assets. Lease liabilities were measured at the present value of the remaining lease payments, discounted with each entity's incremental borrowing rate as at 1 January 2019. The weighted average rate applied by the Group was 2.14% for CPI-linked leases.

At transition to IFRS 16 the Group elected to apply the practical expedient to apply the standard only to contracts previously identified as leases under IAS 17. The Group used the following practical expedients; not to recognise right-of-use assets and liabilities for leases with less than 12 months of lease term and for leases of low-value assets; exclude initial direct costs from measuring right-of-use assets at the date of initial application, and using hindsight when determining the lease term if the contract contains options to extend or terminate the lease.

Reconciliation between IAS 17 lease commitments and IFRS 16 lease liabilities as at 1 January 2019

Operating lease commitments at 31 December 2018 as disclosed in the Group's consolidated financial statements	5,143
Effects of discounting operating lease commitments using the incremental borrowing rate	(593)
Recognition exemption for short-term and low-value asset leases	(61)
Addition for lease commitments for land	16
Lease liabilities recognised as at 1 January 2019	4,505

Lessor accounting under IFRS 16 is substantially unchanged from IAS 17. Lessors will continue to classify leases as either operating or finance leases using similar principles as in IAS 17. Therefore, IFRS 16 did not have an impact on leases where the Group is the lessor.

Changes to IFRS standards issued but not effective at the reporting date

A new IFRS standard and number of amendments to standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Changes that are likely to affect the Group's future financial reporting are described below, no significant impact is expected.

Interest Rate Benchmark Reform

The Group adopted amendments to IFRS 9 – Financial Instruments, IAS 39 – Financial Instruments: Recognition and Measurement, and IFRS 7 – Financial Instruments: Disclosures, as of 1 January 2020. The amendments modify certain hedge accounting requirements, relating to the method that is used to assess the effectiveness of the hedging relationship, to provide relief from potential effect of uncertainty caused by the Interest Rate Benchmark Reform, prior to the transition to alternative interest rates.

The amendments will not have a significant impact on the Group's consolidated financial statements.

3. Cont'd

To manage the transition to alternative interest rates the Bank has set up a working group responsible for the overall transition. A comprehensive review of legacy contracts has been carried out by the Legal department and new contract language been introduced to accommodate the benchmark reform. The work on systems and processes, along with education and communication to major stakeholders, is ongoing. It is expected that financial effects of the transition will be minimal to the Group. The Bank is continually monitoring developments in the benchmark reform work in jurisdictions affected and will adjust its implementation accordingly, should the need arise.

4. Operating segments

Segment information is presented in accordance with the Group's management and internal reporting structure. The Bank has three main business segments: Personal Banking, Business Banking and Corporate & Investment Banking. Operating segments pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium. The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market.

Capital allocation to the business units is 16% of the risk exposure amount (REA) which corresponds to the Bank's CET1 target from the risk appetite statement. Income tax with breakdown for each segment is according to the current tax rate. Bank tax and contribution to the Icelandic Depositors' and Investors' Guarantee Fund are shown separately and allocated across segments. The allocation of the bank tax is based on the expected long-term ratio, as stated in law, or 0.145%.

The Group comprises the following operating segments:

Personal Banking
Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. Íslandsbanki's customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services.

Business Banking
Business Banking provides wide-ranging financial services to small- and medium-sized enterprises. Business Banking is organised around the branches where it can service its customers close to their own business. In addition, Business Banking operates Ergo, the asset based financing unit of the Bank.

Corporate & Investment Banking
Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors and affluent individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage and private banking services. The division is sector-focused, building and maintaining relationships with key customer segments within Iceland. Outside of Iceland, Íslandsbanki has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury and Proprietary Trading
Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business units sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres
Cost centres comprise the CEO's office (Human Resources, Marketing & Communications, Strategy, and Legal), Finance excluding Treasury and Proprietary Trading, IT, Risk Management and Compliance. Group Internal Audit is included in cost centres, however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank's Board of Directors.

Subsidiaries, eliminations and adjustments
Subsidiaries include Borgun hf., Íslandssjóðir hf., Allianz Ísland hf. and other less significant subsidiaries (see Note 28).

Following is an overview showing the Group's performance with a breakdown by operating segments. A change from previous years is that almost all operational results from cost centres have been allocated to the Bank's operating segments. Comparative amounts have not been restated.

Notes to the Consolidated Financial Statements

4. Cont'd

2019	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	10,578	10,812	8,397	3,169	(251)	32,705	971	33,676
Net fee and commission income	4,504	1,716	3,530	(236)	7	9,521	3,838	13,359
Other net operating income	77	25	564	(848)	2,197	2,015	(555)	1,460
Total operating income	15,159	12,553	12,491	2,085	1,953	44,241	4,254	48,495
Salaries and related expenses	(2,791)	(1,993)	(1,720)	(253)	(6,516)	(13,273)	(3,006)	(16,279)
Other operating expenses	(2,131)	(1,184)	(660)	(257)	(5,725)	(9,957)	(1,871)	(11,828)
Contribution to the Depositors' and Investors' Guarantee Fund	(530)	(314)	(89)	(3)	-	(936)	-	(936)
Bank tax	(483)	(339)	(486)	(2,205)	(15)	(3,528)	-	(3,528)
Net impairment on financial assets	(547)	(1,098)	(1,043)	(791)	-	(3,479)	(184)	(3,663)
Cost allocation	(5,606)	(3,381)	(3,421)	278	12,130	-	-	-
Profit (loss) before tax	3,071	4,244	5,072	(1,146)	1,827	13,068	(807)	12,261
Income tax expense	(924)	(1,192)	(1,445)	318	(478)	(3,721)	39	(3,682)
Profit (loss) for the year from continuing operations	2,147	3,052	3,627	(828)	1,349	9,347	(768)	8,579
Net segment revenue from external customers	18,137	14,492	19,191	(9,708)	2,129	44,241	4,254	48,495
Net segment revenue from other segments	(2,978)	(1,939)	(6,700)	11,793	(176)	-	-	-
Fee and commission income	6,224	1,724	3,574	124	8	11,654	9,372	21,026
Depreciation, amortisation and write-offs	(215)	(112)	(21)	-	(1,367)	(1,715)	(245)	(1,960)
At 31 December 2019								
Loans to customers	329,265	230,842	334,788	2	-	894,897	4,735	899,632
Other assets	3,553	3,085	347	267,384	10,648	285,017	14,841	299,858
Total segment assets	332,818	233,927	335,135	267,386	10,648	1,179,914	19,576	1,199,490
Deposits from customers	290,894	167,623	113,455	49,517	-	621,489	(3,176)	618,313
Other liabilities	1,497	1,822	2,553	374,459	6,209	386,540	14,575	401,115
Total segment liabilities	292,391	169,445	116,008	423,976	6,209	1,008,029	11,399	1,019,428
Allocated equity	29,981	38,924	58,953	42,882	1,145	171,885	8,177	180,062
Risk exposure amount	194,601	247,565	367,456	48,063	6,968	864,653	19,897	884,550

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

Íslandsbanki hf. Consolidated Financial Statements 2019 20 Amounts are in ISK million

Notes to the Consolidated Financial Statements

4. Cont'd

2018	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries, eliminations & adjustments	The Group total
Net interest income	9,946	9,788	7,676	3,649	(218)	30,841	1,096	31,937
Net fee and commission income	4,564	1,477	3,321	(109)	12	9,265	2,962	12,227
Other net operating income	1	41	353	1,070	282	1,747	(924)	823
Total operating income	14,511	11,306	11,350	4,610	76	41,853	3,134	44,987
Salaries and related expenses	(2,585)	(2,069)	(1,641)	(258)	(6,185)	(12,738)	(2,762)	(15,500)
Other operating expenses	(2,466)	(1,062)	(680)	(494)	(5,646)	(10,348)	(1,802)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(669)	(395)	(109)	-	-	(1,173)	-	(1,173)
Bank tax	(434)	(327)	(470)	(2,041)	(9)	(3,281)	-	(3,281)
Net impairment on financial assets	579	955	164	(37)	-	1,661	(77)	1,584
Cost allocation	(5,134)	(2,813)	(2,660)	423	10,184	-	-	-
Profit (loss) before tax	3,802	5,595	5,954	2,203	(1,580)	15,974	(1,507)	14,467
Income tax expense	(989)	(1,455)	(1,548)	(1,280)	411	(4,861)	127	(4,734)
Profit (loss) for the year from continuing operations	2,813	4,140	4,406	923	(1,169)	11,113	(1,380)	9,733
Net segment revenue from external customers	14,958	14,996	17,337	(5,733)	295	41,853	3,134	44,987
Net segment revenue from other segments	(447)	(3,690)	(5,987)	10,343	(219)	-	-	-
Fee and commission income	5,990	1,612	3,420	133	12	11,167	8,686	19,853
Depreciation, amortisation and write-offs	(275)	(142)	(26)	(38)	(688)	(1,169)	(143)	(1,312)
At 31 December 2018								
Loans to customers	299,429	219,608	322,974	904	-	842,915	3,684	846,599
Other assets	1,332	3,151	316	252,085	8,056	264,940	18,864	283,804
Total segment assets	300,761	222,759	323,290	252,989	8,056	1,107,855	22,548	1,130,403
Deposits from customers	275,265	164,738	101,417	42,566	-	583,986	(5,027)	578,959
Other liabilities	1,453	2,811	3,199	345,375	2,317	355,155	19,976	375,131
Total segment liabilities	276,718	167,549	104,616	387,941	2,317	939,141	14,949	954,090
Allocated equity	24,582	37,304	57,200	48,982	646	168,714	7,599	176,313
Risk exposure amount	164,795	239,073	360,923	61,986	3,316	830,093	15,856	845,949

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Notes to the Consolidated Financial Statements

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Subsidiaries, eliminations & adjustments

2019	Borgun hf.*	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	872	28	26	36	9	971
Net fee and commission income	1,716	1,089	1,069	(30)	(6)	3,838
Other net operating income	15	156	(1)	(5)	(720)	(555)
Total operating income	2,603	1,273	1,094	1	(717)	4,254
Salaries and related expenses	(2,260)	(558)	(188)	-	-	(3,006)
Other operating expenses	(1,359)	(181)	(471)	(2)	142	(1,871)
Net impairment on financial assets	(184)	-	-	-	-	(184)
(Loss) profit before tax	(1,200)	534	435	(1)	(575)	(807)
Income tax expense	228	(107)	(87)	-	5	39
(Loss) profit for the year from cont. operations	(972)	427	348	(1)	(570)	(768)
Net segment revenue from external customers	3,329	1,475	1,080	(16)	(1,614)	4,254
Net segment revenue from other segments	(726)	(202)	14	17	897	-
Fee and commission income	9,889	1,520	1,069	-	(3,106)	9,372
Depreciation, amortisation and write-offs	(235)	-	(3)	-	(7)	(245)
At 31 December 2019						
Total assets	22,362	2,726	1,201	6,467	(13,180)	19,576
Total liabilities	15,753	302	412	2	(5,070)	11,399
Total equity	6,609	2,424	789	6,465	(8,110)	8,177

*The Bank's shares in Borgun have been in a divestment process since January 2019. The Bank is in discussions with prospective buyers, however, there is still uncertainty as to whether the sale will occur and therefore the Bank has not reclassified the shares in Borgun as assets held for sale.

2018	Borgun hf.	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	1,021	28	19	15	13	1,096
Net fee and commission income	1,104	1,028	950	(31)	(89)	2,962
Other net operating income	3	21	13	519	(1,480)	(924)
Total operating income	2,128	1,077	983	503	(1,556)	3,134
Salaries and related expenses	(2,072)	(529)	(157)	-	(4)	(2,762)
Other operating expenses	(1,323)	(200)	(432)	(3)	156	(1,802)
Net impairment on financial assets	(76)	-	-	-	(1)	(77)
(Loss) profit before tax	(1,343)	348	394	499	(1,405)	(1,507)
Income tax expense	274	(74)	(79)	(1)	7	127
(Loss) profit for the year from cont. operations	(1,069)	274	315	498	(1,398)	(1,380)
Net segment revenue from external customers	2,813	1,217	939	1,125	(2,960)	3,134
Net segment revenue from other segments	(685)	(140)	44	(622)	1,403	-
Fee and commission income	9,331	1,421	950	-	(3,016)	8,686
Depreciation, amortisation and write-offs	(141)	-	(3)	-	1	(143)
At 31 December 2018						
Total assets	28,498	2,466	1,043	9,352	(18,811)	22,548
Total liabilities	22,154	196	231	1,860	(9,492)	14,949
Total equity	6,344	2,270	812	7,492	(9,319)	7,599

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5. Classification of financial assets and financial liabilities

At 31 December 2019	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Fair value through OCI	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	-	146,638	146,638
Loans to credit institutions	-	-	-	-	54,376	54,376
Listed bonds and debt instruments	33,302	-	-	-	-	33,302
Listed bonds and debt instruments used for economic hedging	18,220	-	-	-	-	18,220
Unlisted bonds and debt instruments	1,348	-	-	-	-	1,348
Derivatives	4,700	921	-	-	-	5,621
Loans to customers	-	-	-	-	899,632	899,632
Listed shares and equity instruments	3,779	-	-	-	-	3,779
Listed shares and equity instruments used for economic hedging	8,681	-	-	-	-	8,681
Unlisted shares and equity instruments	2,851	-	-	3,115	-	5,966
Other financial assets	-	-	-	-	5,757	5,757
Total financial assets	72,881	921	-	3,115	1,106,403	1,183,320
Deposits from Central Bank and credit institutions	-	-	-	-	30,925	30,925
Deposits from customers	-	-	-	-	618,313	618,313
Derivative instruments and short positions	6,219	-	-	-	-	6,219
Debt issued and other borrowed funds	-	41,816	49,352	-	215,213	306,381
Subordinated loans	-	-	-	-	22,674	22,674
Other financial liabilities	-	-	-	-	24,772	24,772
Total financial liabilities	6,219	41,816	49,352	-	911,897	1,009,284

At 31 December 2018	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Fair value through OCI	Amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	-	135,056	135,056
Loans to credit institutions	-	-	-	-	41,577	41,577
Listed bonds and debt instruments	45,496	-	-	-	-	45,496
Listed bonds and debt instruments used for economic hedging	22,405	-	-	-	-	22,405
Unlisted bonds and debt instruments	1,514	-	-	-	-	1,514
Derivatives	3,923	627	-	-	-	4,550
Loans to customers	-	-	-	-	846,599	846,599
Listed shares and equity instruments	2,928	-	-	-	-	2,928
Listed shares and equity instruments used for economic hedging	5,458	-	-	-	-	5,458
Unlisted shares and equity instruments	2,846	-	-	1,842	-	4,688
Other financial assets	-	-	-	-	7,511	7,511
Total financial assets	84,570	627	-	1,842	1,030,743	1,117,782
Deposits from Central Bank and credit institutions	-	-	-	-	15,619	15,619
Deposits from customers	-	-	-	-	578,959	578,959
Derivative instruments and short positions	5,521	-	-	-	-	5,521
Debt issued and other borrowed funds	-	40,714	68,154	-	192,108	300,976
Subordinated loans	-	-	-	-	16,216	16,216
Other financial liabilities	-	-	-	-	27,186	27,186
Total financial liabilities	5,521	40,714	68,154	-	830,088	944,477

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6. Fair value information for financial instruments

Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell 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 Group 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.

The table below shows financial instruments carried at fair value at 31 December 2019 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Valuation techniques based on observable inputs other than the quoted prices included in Level 1, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Valuation techniques based on significant unobservable inputs, e.g. internal assumptions.

At 31 December 2019	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	51,522	-	1,348	52,870
Derivatives	-	5,621	-	5,621
Shares and equity instruments	12,383	27	6,016	18,426
Total financial assets	63,905	5,648	7,364	76,917
Short positions	814	-	-	814
Derivative instruments	-	5,405	-	5,405
Debt issued and other borrowed funds designated as at FVTPL	49,352	-	-	49,352
Total financial liabilities	50,166	5,405	-	55,571

At 31 December 2018	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	67,901	-	1,514	69,415
Derivatives	-	4,550	-	4,550
Shares and equity instruments	8,344	42	4,688	13,074
Total financial assets	76,245	4,592	6,202	87,039
Derivative instruments	-	5,521	-	5,521
Debt issued and other borrowed funds designated as at FVTPL	68,154	-	-	68,154
Total financial liabilities	68,154	5,521	-	73,675

Changes in Level 3 assets measured at fair value	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2019	1,514	4,688
Purchases	7	338
Sales and instalments	(537)	(52)
Net gain (loss) on financial instruments recognised in profit or loss	306	(118)
Net gain on financial instruments recognised in other comprehensive income	-	1,272
Other changes	58	(112)
Fair value at 31 December 2019	1,348	6,016

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	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2018	1,828	3,373
Purchases	8	790
Net loss on financial instruments recognised in profit or loss	(249)	(135)
Net gain on financial instruments recognised in other comprehensive income	-	610
Transfers from Level 1 or 2	-	50
Other changes	(73)	-
Fair value at 31 December 2018	1,514	4,688

At the end of each reporting period the Group determines whether transfers have occured between levels in the hierarchy, by reassessing categorisation based on the lowest level input that is significant to the fair value measurement as a whole. No transfers between levels took place in 2019.

Valuation process

The responsibility for the valuation of the fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Valuation techniques

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

Level 1: Fair value established from quoted market prices.

Assets at this level are financial assets and financial liabilities containing actively traded bonds and equities that are listed either domestically or abroad.

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

Assets at this level are assets and liabilities containing domestic bonds, equities as well as derivatives. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates.

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

Assets at this level contain primarily unlisted and illiquid equities and bonds. Unlisted equities and bonds are initially recorded at their transaction price but are revalued each quarter based on the models as described above.

At 31 December 2019 the Group's Level 3 equities amounted to ISK 6,016 million:

-These include shares in seven professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,722 million. The Group receives information from fund managers which use valuation models for the valuation of these equities.

-The Group holds Series C preferred shares in Visa Inc., amounting to ISK 3,115 million, which are subject to selling restrictions for a period of up to 9 years and under certain conditions may have to be recalled. The fair value of the preferred shares is closely linked to the market value of Visa Inc. at NYSE stock exchange, written down by 24% due to uncertainty of the final number of shares and marketability.

-Other Level 3 equities amounting to ISK 1,179 million.

At 31 December 2019 the Group's Level 3 bonds amounted to ISK 1,348 million:

-The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on projected risk and financing cost.

Sensitivity analysis for Level 3 assets

The valuations of Level 3 assets are in general uncertain and subject to various factors. The favourable and unfavourable scenarios can be considered as being likely movements in valuation within a year. The very favourable and very unfavourable scenarios are considered less likely, but not impossible and are not worst-case scenarios for some of the assets.

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The table below shows how profit (loss) and total comprehensive income would have been affected if one or more of the inputs for fair value measurement in Level 3 were changed.

Effect on profit or (loss):	Carrying amount	Very favourable	Favourable	Unfavourable	Very unfavour-able
Level 3 Bonds and debt instruments	1,348	330	257	(296)	(1,348)
Level 3 Shares and equity instruments	2,901	2,399	645	(762)	(1,614)
Effect on comprehensive income:					
Level 3 Shares in Visa Inc.	3,115	1,246	623	(623)	(1,246)

7. Financial instruments not carried at fair value

Assets

The fair value of “Loans to customers” may differ from their net carrying amount because the interest rates they carry may not reflect the interest rates that similar new loans would carry. The fair value is estimated by subtracting from or adding to the net carrying amount of the loans the discounted interest rate difference calculated from the reporting date until the next interest reset or maturity, whichever comes first. Since the interest rate difference is estimated using internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is adequately approximated by the carrying amount as they are short-term in nature. They are thus classified as Level 2.

Liabilities

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. Most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. The fair value for longer term fixed rate deposits is calculated with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

Observed market value is used for the fair value of "Debt issued and other borrowed funds" where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin in the Group's issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions, payments due to leasing contracts and liabilities to retailers for credit card provisions and they are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

The following table shows the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined in Note 6.

At 31 December 2019	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	146,638	-	146,638	146,638
Loans to credit institutions	-	54,376	-	54,376	54,376
Loans to customers	-	-	902,053	902,053	899,632
Other financial assets	-	5,757	-	5,757	5,757
Total financial assets	-	206,771	902,053	1,108,824	1,106,403
Deposits from Central Bank and credit institutions	-	31,027	-	31,027	30,925
Deposits from customers	-	618,592	-	618,592	618,313
Debt issued and other borrowed funds	165,044	100,334	-	265,378	257,029
Subordinated loans	22,626	-	-	22,626	22,674
Other financial liabilities	-	24,772	-	24,772	24,772
Total financial liabilities	187,670	774,725	-	962,395	953,713

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At 31 December 2018	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	135,056	-	135,056	135,056
Loans to credit institutions	-	41,577	-	41,577	41,577
Loans to customers	-	-	848,751	848,751	846,599
Other financial assets	-	7,511	-	7,511	7,511
Total financial assets	-	184,144	848,751	1,032,895	1,030,743
Deposits from Central Bank and credit institutions	-	15,633	-	15,633	15,619
Deposits from customers	-	579,232	-	579,232	578,959
Debt issued and other borrowed funds	151,767	84,476	-	236,243	232,822
Subordinated loans	16,167	-	-	16,167	16,216
Other financial liabilities	-	27,186	-	27,186	27,186
Total financial liabilities	167,934	706,527	-	874,461	870,802

8. Offsetting financial assets and financial liabilities

The tables below show reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2019	Financial assets before netting	Netting with financial liabilities	Net financial assets	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 financial assets recognised in the balance sheet
Reverse repurchase agreements	1,114	-	1,114	-	-	-	1,114	-	1,114
Derivatives	5,621	-	5,621	(1,374)	(3,146)	(88)	1,013	-	5,621
Total assets	6,735	-	6,735	(1,374)	(3,146)	(88)	2,127	-	6,735
At 31 December 2018									
Reverse repurchase agreements	153	-	153	-	-	-	153	-	153
Derivatives	4,550	-	4,550	(1,655)	(1,383)	(698)	814	-	4,550
Total assets	4,703	-	4,703	(1,655)	(1,383)	(698)	967	-	4,703

	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2019	Financial liabilities before netting	Netting with financial assets	Net financial liabilities	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 financial liabilities recognised in the balance sheet
Derivative instruments and short positions	6,219	-	6,219	(1,374)	(1,139)	-	3,706	-	6,219
At 31 December 2018									
Derivative instruments and short positions	5,521	-	5,521	(1,655)	(85)	-	3,781	-	5,521

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9. Quarterly statements (unaudited)

2019	Q4	Q3	Q2	Q1	Total
Net interest income	8,486	8,412	8,626	8,152	33,676
Net fee and commission income	3,646	3,090	3,406	3,217	13,359
Net financial (expense) income	(840)	(598)	173	448	(817)
Net foreign exchange gain (loss)	97	147	(71)	(30)	143
Other operating income	917	44	29	1,144	2,134
Salaries and related expenses	(4,196)	(3,720)	(4,312)	(4,051)	(16,279)
Other operating expenses	(3,130)	(2,698)	(2,961)	(3,039)	(11,828)
Contribution to the Depositors' and Investors' Guarantee Fund	(216)	(210)	(198)	(312)	(936)
Bank tax	(814)	(900)	(934)	(880)	(3,528)
Net impairment on financial assets	(1,585)	(230)	(929)	(919)	(3,663)
Profit before tax	2,365	3,337	2,829	3,730	12,261
Income tax expense	(611)	(1,292)	(626)	(1,153)	(3,682)
Profit for the period from continuing operations	1,754	2,045	2,203	2,577	8,579
Discontinued operations, net of income tax	(95)	41	(83)	12	(125)
Profit for the period	1,659	2,086	2,120	2,589	8,454

2018	Q4	Q3	Q2	Q1	Total
Net interest income	8,294	8,301	7,602	7,740	31,937
Net fee and commission income	3,478	2,939	3,032	2,778	12,227
Net financial (expense) income	(637)	(420)	378	(283)	(962)
Net foreign exchange gain (loss)	76	(8)	(57)	(10)	1
Other operating income	120	64	1,587	13	1,784
Salaries and related expenses	(4,047)	(3,501)	(4,026)	(3,926)	(15,500)
Other operating expenses	(3,418)	(2,962)	(2,846)	(2,924)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(299)	(295)	(287)	(292)	(1,173)
Bank tax	(740)	(944)	(812)	(785)	(3,281)
Net impairment on financial assets	(297)	(53)	1,846	88	1,584
Profit before tax	2,530	3,121	6,417	2,399	14,467
Income tax expense	(1,118)	(1,136)	(1,465)	(1,015)	(4,734)
Profit for the period from continuing operations	1,412	1,985	4,952	1,384	9,733
Discontinued operations, net of income tax	(8)	126	81	713	912
Profit for the period	1,404	2,111	5,033	2,097	10,645

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10. Net interest income

	2019	2018
Cash and balances with Central Bank	4,755	7,279
Loans at amortised cost	55,368	52,462
Financial assets mandatorily at fair value through profit or loss	2,630	1,825
Other assets	93	109
Total interest income	62,846	61,675
Deposits from Central Bank and credit institutions	(625)	(409)
Deposits from customers	(15,241)	(16,539)
Debt issued and other borrowed funds at fair value through profit or loss	(734)	(963)
Debt issued and other borrowed funds at amortised cost	(9,823)	(9,035)
Subordinated loans	(501)	(198)
Other interest expense*	(2,246)	(2,594)
Total interest expense	(29,170)	(29,738)
Net interest income	33,676	31,937

*Thereof is lease liabilities' interest expense amounting to ISK 94 million.

Net interest margin on total assets 2.8% (2018: 2.9%).

11. Net fee and commission income

	2019	2018
Asset management	2,225	2,116
Investment banking and brokerage	2,430	2,303
Payment processing	12,783	12,065
Loans and guarantees	1,510	1,467
Other fee and commission income	2,078	1,902
Total fee and commission income	21,026	19,853
Brokerage	(337)	(300)
Clearing and settlement	(7,293)	(7,302)
Other fee and commission expense	(37)	(24)
Total fee and commission expense	(7,667)	(7,626)
Net fee and commission income	13,359	12,227

Fee and commission income by segment is disclosed in Note 4.

12. Net financial expense

	2019	2018
Net loss on financial assets and liabilities mandatorily at FVTPL	(419)	(720)
Net loss on financial liabilities designated as at FVTPL	(399)	(240)
Net gain (loss) on fair value hedges	1	(2)
Net financial expense	(817)	(962)

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12. Cont'd

	2019	2018
Shares and related derivatives	(572)	(576)
Dividend income	32	38
Bonds and related derivatives	144	(197)
Other derivatives	(23)	15
Net loss on financial assets and liabilities mandatorily at FVTPL	(419)	(720)
Debt issued and other borrowed funds designated as at FVTPL	(399)	(240)
Net loss on financial liabilities designated as at FVTPL	(399)	(240)
Clean fair value gain on interest rate swaps designated as hedging instruments	285	486
Fair value loss on bonds issued by the Group attributable to interest rate risk	(284)	(488)
Net gain (loss) on fair value hedges	1	(2)

13. Net foreign exchange gain

	2019	2018
Cash and balances with Central Bank	(222)	(193)
Financial assets mandatorily at fair value through profit or loss	(1,781)	2,281
Loans at amortised cost	5,686	17,120
Other assets	138	305
Net foreign exchange gain for assets	3,821	19,513
Deposits	(1,749)	(7,938)
Debt issued and other borrowed funds designated as at FVTPL	(1,667)	(3,868)
Debt issued and other borrowed funds at amortised cost	(384)	(6,567)
Subordinated loans	233	(884)
Other liabilities	(111)	(255)
Net foreign exchange loss for liabilities	(3,678)	(19,512)
Net foreign exchange gain	143	1

14. Other operating income

	2019	2018
Share of profit of associates, net of income tax	64	29
Net (loss) gain from sale of subsidiaries	(16)	1,526
Legal dispute settlement*	1,103	-
Legal fees	93	83
Rental income	38	37
Depositor's and Investor's Guarantee Fund reversed contribution**	847	-
Other net operating income	5	109
Other operating income	2,134	1,784

*In February 2019 Íslandsbanki and Old Byr reached an agreement on the settlement of the dispute deriving from the acquisition of Byr savings bank in 2011.

**The Bank had recognised a liability of ISK 847 million against the Depositors' and Investors' Guarantee Fund (the Fund) for the year 2010 in accordance with the Act on Depositor's and Investor's Guarantee Fund at the time. The Icelandic Parliament has since discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter. An amendment to the Act regarding contributions to the Fund was made in 2011 and Icelandic banks have made quarterly payments to a separate division within the Fund since then. The Bank is of the opinion that it is not obliged to pay the expensed contribution from 2010 and therefore the Bank has reversed the previously expensed contribution.

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15. Personnel and salaries

	2019	2018
Salaries	12,565	11,923
Contributions to pension funds	1,849	1,767
Social security charges and financial activities tax*	1,711	1,723
Other salary-related expenses	154	95
Capitalisation of internal staff costs in software development	-	(8)
Salaries and related expenses	16,279	15,500

*Financial activities tax calculated on salaries is 5.5% (2018: 5.5%).

	2019		2018	
	The Bank	The Group	The Bank	The Group
Average number of employees	842	1,079	873	1,076
Positions at year-end	749	984	834	1,075

Total amount of compensation to the Board of Directors, the CEO and Executive Board are specified as follows:

	2019	2018
Friðrik Sophusson, Chairman of the Board	11.3	11.3
Tómas Már Sigurðsson, Vice-Chairman of the Board	6.6	-
Anna Þórðardóttir, member of the Board	7.9	7.8
Auður Finnbogadóttir, member of the Board	7.6	7.5
Árni Stefánsson, member of the Board	7.8	7.5
Hallgrímur Snorrason, member of the Board	7.6	7.5
Heiðrún Jónsdóttir, member of the Board	7.9	7.7
Helga Valfells, former Vice-Chairman of the Board	2.3	9.0
Alternate board members	1.3	0.4
Total salaries	60.3	58.7

Contribution to pension funds for the Board of Directors amounted to ISK 7.1 million in 2019 (2018: ISK 7.2 million).

	2019		2018	
	Total salaries	Contri-butions to pension funds	Total salaries	Contri-butions to pension funds
Birna Einarsdóttir, CEO	50.9	11.9	63.5	14.0
Ásmundur Tryggvason, Managing Director of Corporate & Investment Banking	39.5	5.6	-	-
Guðmundur Kristinn Birgisson, Chief Risk Officer	36.1	5.1	8.0	1.1
Jón Guðni Ómarsson, Chief Financial Officer	41.5	6.1	41.0	6.0
Riaan Dreyer, Director of Information Technology	13.6	2.0	-	-
Sigríður Hrefna Hrafnkelsdóttir, Managing Director of Personal Banking	37.8	5.3	36.0	5.0
Una Steinsdóttir, Managing Director of Business Banking	42.6	6.1	41.9	6.0
Sigríður Olgeirsdóttir, former Director of Information Technology	22.8	3.3	41.5	5.9
Sverrir Örn Þorvaldsson, former Chief Risk Officer	-	-	39.8	6.0
Vilhelm Þorsteinsson, former Managing Director of Corporate & Investment Banking	3.3	0.5	42.1	6.0
Total	288.1	45.9	313.8	50.0

The amounts in the table above comprise salaries for the managing directors for their executive board responsibilities. Included in total salaries are non-monetary benefits such as the use of cars owned by the Group.

As of 1 January 2017, the Bank has not had an active remuneration policy in place as stated in the Bank's compensation policy. Included in total salaries are paid performance-based salaries, which were earned in 2015, and paid by the Bank in 2019. For the Bank's CEO those amounted to ISK 4.1 million (2018: ISK 3.9 million) and for the managing directors the payments amounted to ISK 10.7 million (2018: ISK 12.5 million). The final payment for unpaid performance-based salaries at year-end, based on salaries for 2016, will be paid in April 2020.

There were no share based payments in the years 2019 and 2018.

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16. Other operating expenses

	2019	2018
Professional services	2,051	2,385
Software and IT expenses	4,616	4,568
Real estate and office equipment	1,188	1,796
Depreciation, amortisation and write-offs	1,960	1,312
Other administrative expenses	2,013	2,089
Other operating expenses	11,828	12,150

17. Auditors' fees

	2019	2018
Audit of the annual accounts	125	117
Review of interim accounts	23	24
Other services	5	15
Auditors' fees	153	156

18. Net impairment on financial assets

	2019	2018
Expected credit loss, on-balance sheet items*	(3,524)	529
Expected credit loss, off-balance sheet items	(52)	38
Changes in provision due to court rulings	(87)	1,017
Net impairment on financial assets	(3,663)	1,584

*The main reasons for the additional expected credit loss allowance are: increased loan impairments for a few customers (ISK 1,178 million), due to a less favourable economic environment (ISK 992 million), and an unfavourable ruling in a court case (ISK 787 million).

19. Income tax expense

Recognised income tax is based on applicable tax laws. The income tax rate for legal entities in 2019 is 20% (2018: 20%). Special financial activities tax is calculated as 6% of taxable profits exceeding ISK 1 billion in accordance with the Act on Financial Activities Tax no. 165/2011. The effective income tax rate in the Group's income statement for the year 2019 is 30.1% (2018: 32.7%).

	2019	2018
Current tax expense excluding discontinued operations	2,610	3,205
Special financial activities tax	642	860
Difference in prior year's calculated income tax	(6)	196
Changes in deferred tax assets and deferred tax liabilities	436	473
Income tax recognised in the income statement	3,682	4,734
Income tax recognised in other comprehensive income	(233)	(884)

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19. Cont'd

	2019		2018	
Profit before tax	12,261		14,467	
20% income tax calculated on the profit of the year	2,452	20.0%	2,893	20.0%
Special financial activities tax	642	5.2%	860	5.9%
(Income) expenses not subject to tax	(140)	(1.1%)	217	1.5%
Non-deductible expenses	708	5.8%	657	4.5%
Other differences	20	0.2%	107	0.8%
Effective income tax expense	3,682	30.1%	4,734	32.7%

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

20. Discontinued operations, net of income tax

	2019	2018
Net (loss) profit from foreclosed assets	(199)	58
Net profit from disposal groups held for sale	74	854
Discontinued operations, net of income tax	(125)	912

21. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2019	2018	2019	2018
Profit attributable to shareholders of the Bank	8,934	10,124	8,809	11,036
Weighted average number of outstanding shares	10,000	10,000	10,000	10,000
Basic earnings per share	0.89	1.01	0.88	1.10

The Group's basic and diluted earnings per share are equal as the Group has not issued any options, warrants, convertibles, or other financial instruments that dilute earnings per share (2018: none).

22. Cash and balances with Central Bank

	31.12.2019	31.12.2018
Cash on hand	4,403	3,095
Balances with Central Bank	126,956	114,849
Balances with Central Bank subject to special restrictions*	1,679	3,049
Included in cash and cash equivalents	133,038	120,993
Mandatory reserve deposits with Central Bank	13,600	14,063
Cash and balances with Central Bank	146,638	135,056

*Balances as defined in Act no. 37/2016 on the treatment of króna-denominated assets subject to special restrictions and rules no. 490/2016 on special reserve requirements for new foreign currency inflows.

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23. Loans to credit institutions

	31.12.2019	31.12.2018
Money market loans	33,254	16,314
Bank accounts	21,122	25,259
Other loans	-	4
Loans to credit institutions	54,376	41,577

24. Derivative instruments and short positions

At 31 December 2019	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	1,254	114,393	3,575	96,212
Cross-currency interest rate swaps	3,015	91,950	880	13,073
Equity forwards	141	4,664	298	4,001
Foreign exchange forwards	212	5,460	321	10,217
Foreign exchange swaps	867	30,990	298	24,928
Bond forwards	132	12,756	33	6,219
Derivatives	5,621	260,213	5,405	154,650
Short positions in listed bonds	-	-	814	734
Total	5,621	260,213	6,219	155,384

At 31 December 2018				
Interest rate swaps	1,037	102,429	3,422	134,010
Cross-currency interest rate swaps	1,821	69,691	1,184	28,309
Equity forwards	419	4,596	78	1,195
Foreign exchange forwards	359	9,242	196	3,869
Foreign exchange swaps	875	35,726	440	13,373
Bond forwards	39	3,511	201	19,993
Derivatives	4,550	225,195	5,521	200,749

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

Short positions are in Icelandic Government bonds and bonds issued by institutions with government guarantees. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain EUR denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate EUR denominated bonds (see Note 35) arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. At year-end 2019 the total fair value of the interest rate swaps was positive and amounted to ISK 921 million (2018: ISK 627 million) and their total notional amount was ISK 40,749 million (2018: ISK 39,696).

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25. Loans to customers

At 31 December 2019	Gross carrying amount			Expected credit loss			Net carrying
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3	amount
Individuals	338,335	4,119	9,362	(1,319)	(168)	(1,148)	349,181
Commerce and services	115,679	6,999	6,515	(739)	(194)	(1,772)	126,488
Construction	39,248	849	4,924	(310)	(53)	(238)	44,420
Energy	7,913	-	-	(26)	-	-	7,887
Financial services	2,315	-	-	-	-	-	2,315
Industrial and transportation	77,492	3,338	3,503	(278)	(221)	(1,546)	82,288
Investment companies	19,542	4,369	265	(260)	(216)	(110)	23,590
Public sector and non-profit organisations	12,279	44	15	(23)	(2)	(1)	12,312
Real estate	140,604	3,831	2,345	(542)	(89)	(590)	145,559
Seafood	105,411	249	385	(148)	(10)	(295)	105,592
Loans to customers	858,818	23,798	27,314	(3,645)	(953)	(5,700)	899,632

At 31 December 2018							
Individuals	308,870	5,901	6,860	(1,130)	(256)	(855)	319,390
Commerce and services	118,563	4,981	3,358	(643)	(179)	(1,838)	124,242
Construction	25,958	3,301	298	(196)	(247)	(19)	29,095
Energy	6,145	740	-	(20)	(7)	-	6,858
Financial services	1,708	-	-	(4)	-	-	1,704
Industrial and transportation	74,338	2,625	3,800	(398)	(53)	(488)	79,824
Investment companies	18,709	5,128	398	(217)	(103)	(116)	23,799
Public sector and non-profit organisations	12,054	22	30	(18)	-	(1)	12,087
Real estate	139,073	2,588	2,087	(528)	(154)	(181)	142,885
Seafood	103,014	3,616	479	(123)	(80)	(191)	106,715
Loans to customers	808,432	28,902	17,310	(3,277)	(1,079)	(3,689)	846,599

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26. Expected credit loss

Loans to customers

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2019	3,277	1,079	3,689	8,045
Transfer to Stage 1	1,725	(1,343)	(382)	-
Transfer to Stage 2	(1,336)	1,687	(351)	-
Transfer to Stage 3	(178)	(720)	898	-
Net remeasurement of loss allowance	(1,216)	145	2,727	1,656
New financial assets originated or purchased	1,803	278	353	2,434
Derecognitions and maturities	(430)	(169)	(188)	(787)
Write-offs	-	(4)	(1,616)	(1,620)
Recoveries of amounts previously written off	-	-	249	249
Foreign exchange	-	-	10	10
Unwinding of interests	-	-	311	311
At 31 December 2019	3,645	953	5,700	10,298
At 1 January 2018	2,701	1,244	9,151	13,096
Transfer to Stage 1	2,652	(1,733)	(919)	-
Transfer to Stage 2	(1,053)	2,317	(1,264)	-
Transfer to Stage 3	(99)	(1,167)	1,266	-
Net remeasurement of loss allowance	(2,073)	126	(429)	(2,376)
New financial assets originated or purchased	1,474	478	711	2,663
Derecognitions and maturities	(323)	(185)	(618)	(1,126)
Write-offs	(2)	(1)	(5,254)	(5,257)
Recoveries of amounts previously written off	-	-	416	416
Foreign exchange	-	-	87	87
Unwinding of interests	-	-	542	542
At 31 December 2018	3,277	1,079	3,689	8,045

Total expected credit loss

	Stage 1	Stage 2	Stage 3	Total
Cash and balances with Central Bank	4	-	-	4
Loans to credit institutions	67	-	-	67
Loans to customers	3,645	953	5,700	10,298
Other financial assets	9	3	86	98
Off-balance sheet loan commitments and financial guarantees*	403	55	231	689
At 31 December 2019	4,128	1,011	6,017	11,156
Cash and balances with Central Bank	48	-	-	48
Loans to credit institutions	62	-	-	62
Loans to customers	3,277	1,079	3,689	8,045
Other financial assets	5	3	83	91
Off-balance sheet loan commitments and financial guarantees*	410	142	84	636
At 31 December 2018	3,802	1,224	3,856	8,882

*For further breakdown see Note 39.

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Notes to the Consolidated Financial Statements

27. Investments in associates

		31.12.2019	31.12.2018
Auðkenni hf., an information security company, Borgartún 31, 105 Reykjavík	Iceland	23.8%	23.8%
JCC ehf., a cash centre service company, Borgartún 19, 105 Reykjavík	Iceland	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company, Katrínartún 2, 105 Reykjavík	Iceland	30.8%	30.8%

	2019	2018
Investments in associates at the beginning of the year	682	704
Additions during the year	-	86
Sales of shares in associates	-	(39)
Transfer from associates to subsidiaries	-	(80)
Share of gain of associates	64	29
Dividends paid	-	(18)
Investments in associates	746	682

Summarised financial information in respect of the Group's associates is set out below:	2019	2018
Revenue	6,259	5,487
Profit	281	171
Assets	5,445	5,291
Liabilities	(2,832)	(2,932)
Net assets	2,613	2,359
Group's share of net assets of associates	746	682

28. Investments in subsidiaries

		31.12.2019	31.12.2018
Borgun hf., a payment acquirer and issuing processor, Ármúli 30, 108 Reykjavík	Iceland	63.5%	63.5%
B-Payment Group Szolgáltató Zrt., a payment processing company, H-1132 Budapest	Hungary	100%	100%
Íslandssjóðir hf., an investment fund management company, Hagasmári 3, 201 Kópavogur	Iceland	100%	100%
Hringur-eignarhaldsfélag ehf., a holding company, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%

In addition Íslandsbanki has control over nine other non-significant subsidiaries.

Borgun hf. is the only subsidiary of Íslandsbanki that has a material non-controlling interest, 2019: 36.5% (2018: 36.5%). The following table summarises key information relevant to Borgun hf. The amounts shown are before inter-company eliminations.

	2019	2018
Loans at amortised cost	7,780	7,425
Other assets	14,582	21,073
Liabilities	15,753	22,154
Net assets	6,609	6,344
Carrying amount of non-controlling interests	2,412	2,318
Revenue	10,807	10,383
Loss for the year	(972)	(1,069)
Other comprehensive income for the year, net of tax	1,272	610
Total comprehensive income	300	(459)
Profit (loss) allocated to non-controlling interests	110	(167)
Net cash used in operating activities	(1,679)	(4,500)
Net cash provided by investing activities	75	371
Net cash (used in) provided by financing activities	(405)	19
Net decrease in cash and cash equivalents	(2,009)	(4,110)

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29. Property and equipment

At 31 December 2019	Land and buildings	Right-of-use assets: Land, buildings & vehicles	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	4,054	-	3,984	8,038
Impact of adopting IFRS 16, see Note 3	-	4,505	-	4,505
Additions during the year	56	3	271	330
Disposals and write-offs during the year	(14)	-	(187)	(201)
Remeasurement	-	126	-	126
Historical cost	4,096	4,634	4,068	12,798
Balance at the beginning of the year	(1,402)	-	(1,365)	(2,767)
Depreciation during the year	(47)	(420)	(574)	(1,041)
Disposals and write-offs during the year	2	-	176	178
Accumulated depreciation	(1,447)	(420)	(1,763)	(3,630)
Carrying amount	2,649	4,214	2,305	9,168
Annual deprecion rates	0-2%	3-33%	8-35%	

Official real estate value of land and buildings	2,240
Insurance value of buildings	3,545
Insurance value of fixtures, equipment and vehicles	3,429

At 31 December 2018	Land and buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	5,722	4,683	10,405
Additions during the year	15	829	844
Disposals and write-offs during the year	(1,683)	(1,528)	(3,211)
Historical cost	4,054	3,984	8,038
Balance at the beginning of the year	(1,330)	(1,947)	(3,277)
Depreciation during the year	(72)	(496)	(568)
Disposals and write-offs during the year	-	1,078	1,078
Accumulated depreciation	(1,402)	(1,365)	(2,767)
Carrying amount	2,652	2,619	5,271
Annual deprecion rates	0-2%	8-33%	

Official real estate value of buildings and land	3,747
Insurance value of buildings	4,889
Insurance value of fixtures, equipment and vehicles	3,500

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Notes to the Consolidated Financial Statements

30. Intangible assets

At 31 December 2019	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,639	3,644	248	5,531
Additions during the year and internal development	169	7	70	246
Write-offs during the year	(26)	(268)	-	(294)
Historical cost	1,782	3,383	318	5,483
Balance at the beginning of the year	(222)	(307)	-	(529)
Amortisation during the year	(313)	(318)	-	(631)
Write-offs during the year	7	-	-	7
Accumulated amortisation	(528)	(625)	-	(1,153)
Carrying amount	1,254	2,758	318	4,330
Amortisation rates	10-25%	10-25%	-	

At 31 December 2018	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,381	3,090	-	4,471
Additions during the year and internal development	479	555	248	1,282
Write-offs during the year	(221)	(1)	-	(222)
Historical cost	1,639	3,644	248	5,531
Balance at the beginning of the year	(39)	(201)	-	(240)
Amortisation during the year	(345)	(106)	-	(451)
Write-offs during the year	162	-	-	162
Accumulated amortisation	(222)	(307)	-	(529)
Carrying amount	1,417	3,337	248	5,002
Amortisation rates	10-25%	10-25%	-	

31. Other assets

	31.12.2019	31.12.2018
Receivables	4,810	5,793
Unsettled securities transactions	279	1,033
Accruals	253	289
Prepaid expenses	468	395
Deferred tax assets	476	215
Other assets	322	222
Non-current assets and disposal groups held for sale	1,075	1,230
Other assets	7,683	9,177

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31. Cont'd

Non-current assets and disposal groups held for sale	31.12.2019	31.12.2018
Repossessed collateral:		
Land and buildings	739	995
Industrial equipment and vehicles	44	17
Assets of disposal groups classified as held for sale	292	218
Total	1,075	1,230

At year-end 2019 the Group classified the assets and liabilities of Miðengi ehf. (100%) as assets and liabilities of disposal groups held for sale.

32. Deposits from Central Bank and credit institutions

	31.12.2019	31.12.2018
Deposits from credit institutions	30,808	15,527
Repurchase agreements with Central Bank	117	92
Deposits from Central Bank and credit institutions	30,925	15,619

33. Deposits from customers

	31.12.2019	31.12.2018
Demand deposits and deposits with maturity up to 3 months	530,960	499,170
Term deposits with maturity of more than 3 months	87,353	79,789
Deposits from customers	618,313	578,959

Deposits from customers specified by owners	31.12.2019		31.12.2018	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	12,553	2%	9,331	2%
Municipalities	5,619	1%	5,574	1%
Companies	299,204	48%	278,209	48%
Individuals	300,937	49%	285,845	49%
Deposits from customers	618,313	100%	578,959	100%

34. Pledged assets

	31.12.2019	31.12.2018
Financial assets pledged as collateral against liabilities	205,773	190,471
Financial assets pledged as collateral in foreign banks	402	1,105
Financial assets pledged as collateral in repurchase agreements	1,114	153
Pledged assets against liabilities	207,289	191,729

The Group has pledged assets against the issuance of covered bonds under Icelandic law, which are pledged on a pool of consumer mortgage loans.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

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35. Debt issued and other borrowed funds

	Issued	Maturity		Interest	31.12.2019	31.12.2018
Covered bonds in ISK*	2014-2017	2019	At maturity	Fixed rates	-	9,866
Covered bonds in ISK	2019	2021	At maturity	Fixed rates	3,918	-
Covered bonds in ISK	2015-2019	2023	At maturity	Fixed rates	20,170	10,890
Covered bonds in ISK - CPI-linked*	2012-2014	2019	At maturity	Fixed rates	-	8,937
Covered bonds in ISK - CPI-linked	2014-2015	2020	At maturity	Fixed rates	4,359	4,248
Covered bonds in ISK - CPI-linked	2015-2017	2022	At maturity	Fixed rates	18,512	18,009
Covered bonds in ISK - CPI-linked	2012-2018	2024	At maturity	Fixed rates	35,752	35,009
Covered bonds in ISK - CPI-linked	2015-2018	2026	At maturity	Fixed rates	27,661	26,992
Covered bonds in ISK - CPI-linked	2019	2028	At maturity	Fixed rates	14,228	-
Covered bonds in ISK - CPI-linked	2017-2018	2030	At maturity	Fixed rates	25,463	24,862
Covered bonds					150,063	138,813
Senior unsecured bonds in SEK	2015	2019	At maturity	Fixed rates	-	7,844
Senior unsecured bonds in EUR	2017	2019	At maturity	Fixed rates	-	4,398
Senior unsecured bonds in SEK	2018	2019	At maturity	Fixed rates	-	1,302
Senior unsecured bonds in EUR**	2016	2020	At maturity	Fixed rates	7,782	68,154
Senior unsecured bonds in SEK*	2018	2020	At maturity	Fixed rates	-	3,259
Senior unsecured bonds in SEK	2019	2020	At maturity	Floating rates	4,557	-
Senior unsecured bonds in SEK	2018	2021	At maturity	Fixed rates	1,308	1,311
Senior unsecured bonds in SEK	2018-2019	2021	At maturity	Floating rates	18,913	15,053
Senior unsecured bonds in EUR	2019	2021	At maturity	Floating rates	1,559	-
Senior unsecured bonds in SEK	2018	2022	At maturity	Floating rates	12,990	12,995
Senior unsecured bonds in EUR**	2019	2022	At maturity	Fixed rates	41,570	-
Senior unsecured bonds in NOK	2019	2022	At maturity	Floating rates	13,856	-
Senior unsecured bonds in EUR***	2018	2024	At maturity	Fixed rates	41,816	40,714
Senior unsecured bonds in NOK	2019	2024	At maturity	Fixed rates	5,709	-
Senior unsecured bonds in ISK	2019	2024	Monthly	Floating rates	3,553	-
Bonds issued					153,613	155,030
Bills issued					2,705	6,729
Other debt securities					-	404
Other borrowed funds					2,705	7,133
Debt issued and other borrowed funds					306,381	300,976

*The Bank repurchased own bonds during the year amounting to ISK 7,614 million.

**These bond issuances are classified as being designated as at fair value through profit or loss. At 31 December 2019 the total carrying amount of the bonds amounted to ISK 49,352 million and included in the amount are fair value changes amounting to ISK 863 million. The carrying amount of the bond at 31 December 2019 was ISK 367 million higher than the contractual amount due at maturity. Íslandsbanki repurchased part of the bond issuance maturing in 2020 during the year, amounting to ISK 62,227 million.

***The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments (see Note 24). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. At 31 December 2019 the total carrying amount of the bond issuance amounted to ISK 41,816 million and included in the amount are fair value changes amounting to ISK 771 million.

The Bank has issued additional covered bonds to hold for the purpose of securities lending with regards to market making agreements. These covered bond amounts are not included in the total.

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36. Subordinated loans

	Issued	Maturity		Interest	31.12.2019	31.12.2018
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	At maturity	Floating, STIBOR + 2.0%	9,714	9,724
Subordinated loans in SEK	2018	2028	At maturity	Floating, STIBOR + 2.5%	6,485	6,492
Subordinated loans in SEK	2019	2029	At maturity	Floating, STIBOR + 3.9%	6,475	-
Subordinated loans					22,674	16,216

37. Changes in liabilities arising from financing activities

			Non-cash changes			
	1.1.2019	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.12.2019
Covered bonds in ISK	20,756	2,060	1,272	-	-	24,088
Covered bonds in ISK - CPI-linked	118,057	1,263	6,655	-	-	125,975
Senior unsecured bonds in ISK	-	3,528	25	-	-	3,553
Senior unsecured bonds FX	46,162	12,139	1,016	(425)	-	58,892
Senior unsecured bonds FX at fair value	68,154	(22,509)	734	1,667	1,306	49,352
Senior unsecured bonds used for hedging	40,714	(465)	497	786	284	41,816
Other borrowed funds	7,133	(4,809)	358	23	-	2,705
Subordinated loans	16,216	6,190	501	(233)	-	22,674
Total	317,192	(2,603)	11,058	1,818	1,590	329,055

					Non-cash changes			
	31.12.2017	Reclassi-fication & remeasure	1.1.2018	Cash flows	Interest expense	Foreign exchange	Fair value changes	31.12.2018
Covered bonds in ISK	17,589	-	17,589	2,055	1,112	-	-	20,756
Covered bonds in ISK - CPI-linked	91,351	-	91,351	20,134	6,572	-	-	118,057
Senior unsecured bonds FX	37,182	(19,003)	18,179	23,275	531	4,177	-	46,162
Senior unsecured bonds FX at fair value	-	84,563	84,563	(20,083)	963	3,868	(1,157)	68,154
Senior unsecured bonds used for hedging ..	63,652	(63,652)	-	37,406	430	2,390	488	40,714
Other borrowed funds	7,974	-	7,974	(1,231)	390	-	-	7,133
Subordinated loans	9,505	-	9,505	5,629	198	884	-	16,216
Total	227,253	1,908	229,161	67,185	10,196	11,319	(669)	317,192

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38. Tax assets and tax liabilities

	31.12.2019		31.12.2018	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,670	-	6,472
Deferred tax	476	1,183	215	678
Tax in the balance sheet	476	7,853	215	7,150

Changes in the deferred tax assets and the tax liabilities were as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2018	4	88
Calculated income tax for 2018	211	3,888
Income tax payable in 2019	-	(3,214)
Income tax recognised in other comprehensive income	-	(94)
Prior year's income tax adjustment	-	10
Deferred tax assets and tax liabilities 31.12.2018	215	678
Calculated income tax for 2019	256	3,223
Income tax payable in 2020	-	(2,535)
Income tax recognised in other comprehensive income	9	(183)
Prior year's income tax adjustment	(4)	-
Deferred tax assets and tax liabilities 31.12.2019	476	1,183

Movements in temporary differences during the year were as follows:

				Balance at 31 December		
2019	Net balance at 1 January	Recognised in profit or (loss)	Recognised in equity	Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(249)	(848)	-	(1,097)	-	(1,097)
Intangible assets	(527)	16	-	(511)	-	(511)
Assets and liabilities denominated in foreign currency	(264)	(12)	-	(276)	-	(276)
Deferred foreign exchange difference	(213)	(213)	-	(426)	-	(426)
Derivatives	194	(236)	-	(42)	-	(42)
Lease liabilities	-	851	-	851	851	-
Debt issued and other borrowed funds	329	(253)	192	268	268	-
Other items	(2)	32	-	30	30	-
Tax loss carry forwards	269	227	-	496	496	-
	(463)	(436)	192	(707)	1,645	(2,352)
Set-off of deferred tax assets together with liabilities of the same taxable entities					(1,169)	1,169
Tax assets (liabilities)	(463)	(436)	192	(707)	476	(1,183)

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2018	Net balance at 1 January	Recognised in profit or (loss)	Recognised in equity	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(79)	(170)	-	(249)	-	(249)
Intangible assets	(395)	(132)	-	(527)	-	(527)
Assets and liabilities denominated in foreign currency	(186)	(78)	-	(264)	-	(264)
Deferred foreign exchange difference	(202)	(11)	-	(213)	-	(213)
Derivatives	465	(271)	-	194	194	-
Debt issued and other borrowed funds	314	(79)	94	329	329	-
Other items	(1)	(1)	-	(2)	-	(2)
Tax loss carry forwards	-	269	-	269	269	-
	(84)	(473)	94	(463)	792	(1,255)
Set-off of deferred tax assets together with liabilities of the same taxable entities					(577)	577
Tax assets (liabilities)	(84)	(473)	94	(463)	215	(678)

39. Other liabilities

	31.12.2019	31.12.2018
Accruals	3,217	3,906
Liabilities to retailers for credit cards	14,765	20,722
Lease liabilities	4,256	-
Provision for effects of court rulings	75	-
Expected credit loss for off-balance sheet loan commitments and financial guarantees	689	636
Withholding tax	1,559	1,733
Unsettled securities transactions	515	612
Deferred income	229	193
Sundry liabilities	1,758	1,841
Non-current liabilities and disposal groups held for sale	-	6
Other liabilities	27,063	29,649

Expected credit loss for off-balance sheet loan commitments and financial guarantees

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2019	410	142	84	636
Transfer to Stage 1	152	(81)	(71)	-
Transfer to Stage 2	(20)	39	(19)	-
Transfer to Stage 3	(9)	(18)	27	-
Net remeasurement of loss allowance	(455)	(27)	131	(351)
New loan commitments and financial guarantees	447	20	119	586
Derecognitions and maturities	(122)	(20)	(40)	(182)
At 31 December 2019	403	55	231	689
At 1 January 2018	467	101	106	674
Transfer to Stage 1	595	(545)	(50)	-
Transfer to Stage 2	(58)	67	(9)	-
Transfer to Stage 3	(6)	(69)	75	-
Net remeasurement of loss allowance	(828)	481	(132)	(479)
New loan commitments and financial guarantees	521	130	132	783
Derecognitions and maturities	(281)	(23)	(38)	(342)
At 31 December 2018	410	142	84	636

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40. Custody assets

	31.12.2019	31.12.2018
Custody assets - not managed by the Group	2,898,686	2,167,946

41. Leases

The Group as a lessee

The Group adopted a new IFRS standard, IFRS 16 - Leases as of 1 January 2019 (see Note 3). As a result of the adoption the Group changed its accounting policy for leases (see Note 66.10).

The Group's significant leases are leases for offices, branches and storage but the Group also leases land and vehicles. Most leases are CPI-linked real estate leases with duration of 5-10 years with extension options. Lease commitments are recognised on-balance sheet except for short-term leases and leases of low-value assets. Total expense for leases of low-value assets and short-term leases amounted to ISK 21 million during the year 2019.

Total cash outflow for leases amounted to ISK 493 million (2018: ISK 492 million).

Right-of-use assets are presented in the line item “Property and equipment” (see Note 29). Lease liabilities are presented in the line item “Other liabilities” (see Note 39).

At 31 December 2018 the future non-cancellable minimum operating lease payments where the Group was a lessee was:

	31.12.2018
Due within 1 year	470
Due in 1-5 years	1,831
Due in more than 5 years	2,842
Operating lease commitments	5,143

The Group as a lessor

Net investment in finance lease receivables

	31.12.2019	31.12.2018
Due within 1 year	17,559	18,524
Due in 1-5 years	30,960	30,195
Due in more than 5 years	3,538	3,011
Total gross investment in the lease	52,057	51,730
Due within 1 year	15,303	16,069
Due in 1-5 years	27,628	26,730
Due in more than 5 years	2,692	2,317
Total present value of lease payments*	45,623	45,116
Unearned interest income	6,434	6,614

*The Group presents finance lease receivables in the line item “Loans to customers”.

Expected credit loss allowance	202	193
Interest income from finance lease receivables during the year	3,165	3,166

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42. Related party

Íslandsbanki is wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments (ISFI). As a result, the Icelandic Government and the Icelandic State Financial Investments are defined as related parties. The Group has applied the partial exemption for government-related entities, as described in IAS 24, and does not disclose those transactions in the related party note.

The Board of Directors and key management personnel of the Bank, ISFI and subsidiaries of the Bank, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner the Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third party counterparties.

Cash and balances with the Central Bank are disclosed under Note 22 and Deposits from the Central Bank are disclosed under Note 32.

All loans to employees are provided on general business terms of the Group and the balances do not reflect collaterals held by the Group.

At 31 December 2019	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Board of Directors, key management personnel and other related parties	324	392	(68)	51
Associated companies	16	830	(814)	213
Balances with related parties	340	1,222	(882)	264

2019	Interest income	Interest expense	Other income	Other expense
Board of Directors, key management personnel and other related parties	25	7	1	-
Associated companies	7	17	3	1,620
Transactions with related parties	32	24	4	1,620

At 31 December 2018	Assets	Liabilities	Net balance	Commitments, guarantees & overdrafts
Shareholders with control over the Group	-	105	(105)	-
Board of Directors, key management personnel and other related parties	220	493	(273)	82
Associated companies	198	469	(271)	210
Balances with related parties	418	1,067	(649)	292

2018	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	2	-	-
Board of Directors, key management personnel and other related parties	16	10	2	-
Associated companies	15	10	2	1,937
Transactions with related parties	31	22	4	1,937

At year-end 2019 ISK 2 million were recognised as Stage 1 expected credit loss against balances outstanding with related parties (2018: ISK 2 million). No share option programmes were operated during the reporting period. For related party remuneration see Note 15.

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43. Contingencies

Contingent liabilities

Borgun hf.

Borgun hf., a subsidiary of Íslandsbanki, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun in late 2014. Landsbankinn claims that Borgun's management did not disclose all available information that might have affected the value of Borgun during the sales process, namely the worth of its stake in Visa Europe which was sold to Visa International shortly after the Borgun sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit against Borgun hf. and others on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. Landsbankinn does not quantify the claim, but its estimate of the lost profit from having sold its shares in Borgun is approximately ISK 1,930 million. Seeing that the conclusion of the case is uncertain and the financial effect cannot be estimated the Group has not recognised a provision in relation to this matter. Court appointed surveyors presented their assessment in November 2019. A reassessment has been demanded. It is uncertain when a ruling is to be expected.

44. Events after the reporting period

No events have arisen after the reporting period that require amendments or additional disclosures in the consolidated financial statements for the year ended 31 December 2019.

45. Risk management

Risk governance

The Group is exposed to various risk factors and managing these risks is an integral part of its operations. The Bank emphasises sound governance principles. The risk management and internal control framework of the Group is based on a three lines of defence model, as referred to in the European Banking Authority Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Group’s internal rules.

The first line of defence consists of the Bank's business and support units; the second line of defence comprises the Bank's internal control units, risk management and compliance; and the third line of defence is Internal Audit which gives the Board an independent assessment of the quality of corporate governance, risk management and internal controls.

The Group's management body has a dual structure. The Board of Directors of the Bank has a supervising role in setting and monitoring the execution of set policies, the sound control of accounting and financial management and ensuring that group internal audit, compliance and risk management are effective. The Chief Executive Officer (CEO), the Chief Risk Officer (CRO), other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at the Group lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through risk management policies and the Risk Appetite Statement. To assist the Board in fulfilling its oversight responsibilities, the Board has appointed three board subcommittees.

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Group's operations are consistent with applicable legislation and the Group's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer, the Compliance Officer as well as other members of the Executive Board. The CEO also engages the members of the senior management committees.

The CRO heads the risk management function and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at the Group and for verifying that the Bank has the right resources and an appropriate organisation to manage its risks efficiently.

The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the Group and cannot be removed without the Board's prior approval.

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The CRO is independent from the business units, is a member of the Executive Board and reports directly to the CEO. The CRO provides an independent view on the Group's exposure to risk. The CRO has the right but not the responsibility to veto certain risk-taking decisions of the senior management committees if an internal control unit considers the proposal inconsistent with the Bank's risk appetite, policies or procedures.

Risk management is mandated to identify, understand, measure and monitor the risks that the Group is exposed to. It provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by the management and business or support units as to whether they are consistent with the risk appetite and risk polices set by the Board.

Where necessary, risk management makes recommendations to senior management and the Board to improve or clarify risk policies, procedures and limits.

Risk Management provides a holistic view on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

Business and support units are, however, responsible for maintaining their independent view on the risks inherent in their operations and reporting to senior management any foreseeable breaches from limits, policies or strategic direction.

Risk management provides the senior management and the Board with all relevant risk related information to enable it to define the Bank's risk appetite.

The General Counsel is appointed by and reports directly to the CEO. The General Counsel provides legal advice to the Bank's senior management, including the Board of Directors, and manages the Bank's legal department which provides comprehensive legal advice to the Bank's business segments and support units.

The Chief Audit Executive (CAE) is appointed by the Board, reports directly to Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Group, including internal audit tasks which have been outsourced.

The Compliance Officer heads the compliance function and is responsible for defining the daily tasks of the department and assessing the adequacy of its professional skills. The Compliance Officer is responsible for monitoring the compliance risk management framework for the Bank and maintaining oversight for compliance risk throughout the Bank.

The Bank's Compliance Officer is selected and engaged by the CEO, subject to Board confirmation. The Compliance Officer cannot be removed without the Board's prior approval. The Financial Supervisory Authority and Chief Audit Executive shall be notified of the dismissal or departure of the Compliance Officer.

The Compliance Officer reports directly to the Board on the overall compliance risk profile of the Bank.

Each employee is responsible for understanding the risk related to their day-to-day work, for knowing and understanding the respective internal and external rules and procedures, for using the alert procedures in the event of possible fraudulent activities and for conducting business in accordance with the Bank's code of conduct.

The Bank's senior management committee structure is twofold. Firstly the two executive committees, the Executive Board and the All Risk Committee, that are responsible for the implementation of the Board approved business strategy, risk appetite and policies. Secondly the four business committees, the Asset and Liability Committee (ALCO), the Senior Credit Committee (SCC), the Investment Committee (IC) and the Operational and Security Committee (OSC), which are responsible for the approval of business or operational proposals subject to internal rules and guidelines issued by the executive committees and the Board.

The members of the senior management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter issued by the CEO.

More information about the Group's risk management and risk assessment processes is available in the unaudited Pillar 3 2019 Report, which is available on the Bank's website: www.islandsbanki.is.

46. Credit risk

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 financial contract with the Group.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. industrial sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes 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 loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as financial guarantees, loan commitments and derivatives.

The Group has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Group's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Group measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

47. Maximum credit exposure

The Group'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. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions that have been made because of these items. The maximum credit exposure for a derivative contract is calculated by adding potential future credit exposure to the positive market value of the contract.

The industry breakdown shows the 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 Group's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

At 31 December 2019	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	146,638	-	-	-	-	-	-	-	-	-	146,638
Loans to credit institutions	-	-	-	-	-	54,376	-	-	-	-	-	54,376
Bonds and debt instruments	-	33,007	-	-	125	16,131	1,296	52	1,027	1,232	-	52,870
Derivatives	-	-	706	-	1,836	5,788	189	530	-	208	228	9,485
Loans to customers:	349,181	-	126,488	44,420	7,887	2,315	82,288	23,590	12,312	145,559	105,592	899,632
Overdrafts	12,333	-	14,506	3,425	110	2,289	4,927	654	1,204	3,220	6,270	48,938
Credit cards	16,466	-	1,579	271	5	24	437	40	106	63	35	19,026
Mortgages	281,450	-	5	-	-	-	-	-	-	44	-	281,499
Capital leases	5,774	-	28,422	2,700	15	-	7,322	139	39	1,005	207	45,623
Other loans	33,158	-	81,976	38,024	7,757	2	69,602	22,757	10,963	141,227	99,080	504,546
Other financial assets	532	-	199	7	6	4,803	117	41	10	36	6	5,757
Off-balance sheet items:	33,964	-	24,605	16,035	2,974	6,579	18,865	548	3,461	19,036	9,738	135,805
Financial guarantees	1,477	-	6,035	4,914	-	1,172	2,907	95	5	2,004	252	18,861
Undrawn loan commitments	-	-	1,871	8,297	2,442	-	9,726	-	-	11,303	1,804	35,443
Undrawn overdrafts	9,842	-	12,476	2,063	503	5,291	5,135	314	2,733	5,456	7,525	51,338
Credit card commitments	22,645	-	4,223	761	29	116	1,097	139	723	273	157	30,163
Maximum credit exposure	383,677	179,645	151,998	60,462	12,828	89,992	102,755	24,761	16,810	166,071	115,564	1,304,563

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At 31 December 2018	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	135,056	-	-	-	-	-	-	-	-	-	135,056
Loans to credit institutions	-	-	-	-	-	41,577	-	-	-	-	-	41,577
Bonds and debt instruments	-	53,341	-	-	447	12,925	1,724	68	724	186	-	69,415
Derivatives	-	-	121	2	2,322	4,687	451	1,090	-	61	205	8,939
Loans to customers:	319,390	-	124,242	29,095	6,858	1,704	79,824	23,799	12,087	142,885	106,715	846,599
Overdrafts	11,769	-	11,699	3,304	31	1,509	4,483	780	754	4,501	9,751	48,581
Credit cards	15,779	-	1,516	251	4	21	433	33	112	59	34	18,242
Mortgages	249,296	-	-	-	-	-	-	-	-	-	-	249,296
Capital leases	6,504	-	27,552	2,270	5	-	7,166	116	48	1,197	258	45,116
Other loans	36,042	-	83,475	23,270	6,818	174	67,742	22,870	11,173	137,128	96,672	485,364
Other financial assets	409	-	451	5	1	6,532	23	34	3	18	35	7,511
Off-balance sheet items:	33,928	-	24,673	18,703	6,091	8,160	12,413	3,817	4,517	20,850	12,805	145,957
Financial guarantees	1,494	-	5,863	4,563	12	1,172	2,416	160	5	1,828	508	18,021
Undrawn loan commitments	-	-	4,986	11,662	5,996	-	4,899	1,100	-	14,629	5,782	49,054
Undrawn overdrafts	10,187	-	9,908	1,830	63	6,863	4,124	2,433	3,884	4,167	6,374	49,833
Credit card commitments	22,247	-	3,916	648	20	125	974	124	628	226	141	29,049
Maximum credit exposure	353,727	188,397	149,487	47,805	15,719	75,585	94,435	28,808	17,331	164,000	119,760	1,255,054

48. 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 Group takes a charge over assets such as real estate, vessels, cash and securities 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 Group 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.

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Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Group'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 the gross carrying amount of loans and nominal off-balance sheet items, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their gross carrying amount, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. The maximum credit risk exposure is measured on net carrying value basis, and therefore collateral allocation can in some instances be higher. For capital leases the Group remains the owner of the leased object. In total ISK 37,035 million of the collateral are leased objects.

The following tables show the maximum exposure to credit risk by class of financial asset and collateral held against those exposures. An overview of collateral held by the Group against credit exposure is shown below for exposures in Stages 1 and 2 (non credit-impaired) and exposures in Stage 3 (credit-impaired):

At 31 December 2019 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Net exposure	Associated ECL
Derivatives	9,485	-	-	1,757	-	-	1,757	7,728	-
Loans and commitments to customers:	1,012,821	622,021	87,217	7,001	49,865	80,043	846,147	166,674	5,056
Individuals	374,718	292,701	7	417	13,317	116	306,558	68,160	1,579
Commerce and services	146,149	63,151	777	961	27,124	25,891	117,904	28,245	1,030
Construction	55,236	40,432	4	653	2,130	3,968	47,187	8,049	495
Energy	10,861	5,655	-	366	8	5	6,034	4,827	34
Financial services	8,894	-	-	123	-	3,621	3,744	5,150	7
Industrial and transportation	99,188	49,944	12	107	6,757	18,566	75,386	23,802	534
Investment companies	23,982	7,748	-	3,281	71	11,930	23,030	952	478
Public sector and non-profit organisations	15,758	958	-	7	29	-	994	14,764	29
Real estate	162,795	148,919	5	1,072	301	1,125	151,422	11,373	702
Seafood	115,240	12,513	86,412	14	128	14,821	113,888	1,352	168
Total	1,022,306	622,021	87,217	8,758	49,865	80,043	847,904	174,402	5,056
Collateral held against credit-impaired exposures									
Loans and commitments to customers:	22,616	17,100	1,481	333	846	830	20,590	2,026	5,931
Individuals	8,427	7,191	17	12	166	2	7,388	1,039	1,245
Commerce and services	4,944	2,980	102	22	561	805	4,470	474	1,864
Construction	5,219	4,919	-	197	19	7	5,142	77	261
Industrial and transportation	1,965	253	1,331	102	72	16	1,774	191	1,559
Investment companies	156	149	-	-	-	-	149	7	111
Public sector and non-profit organisations	15	14	-	-	-	-	14	1	1
Real estate	1,800	1,567	-	-	9	-	1,576	224	595
Seafood	90	27	31	-	19	-	77	13	295
Total	22,616	17,100	1,481	333	846	830	20,590	2,026	5,931

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At 31 December 2018

Collateral held against non credit-impaired exposures	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Net exposure	Associated ECL
Derivatives	8,939	-	-	2,232	-	-	2,232	6,707	-
Loans and commitments to customers:	978,396	563,362	89,350	6,149	49,883	69,902	778,646	199,750	4,908
Individuals	347,490	266,508	6	359	13,485	155	280,513	66,977	1,508
Commerce and services	146,286	56,407	733	189	27,574	23,915	108,818	37,468	918
Construction	47,495	28,694	-	379	1,880	3,761	34,714	12,781	624
Energy	12,949	3,737	-	366	-	5	4,108	8,841	32
Financial services	9,864	-	-	309	-	-	309	9,555	17
Industrial and transportation	89,289	39,523	9	82	6,437	15,980	62,031	27,258	481
Investment companies	27,392	9,588	26	2,891	83	11,361	23,949	3,443	358
Public sector and non-profit organisations	16,551	974	-	7	37	2	1,020	15,531	22
Real estate	161,864	144,530	-	1,549	231	1,113	147,423	14,441	737
Seafood	119,216	13,401	88,576	18	156	13,610	115,761	3,455	211
Total	987,335	563,362	89,350	8,381	49,883	69,902	780,878	206,457	4,908

Collateral held against credit-impaired exposures	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral	Net exposure	Associated ECL
Loans and commitments to customers:	14,160	9,003	2,282	106	328	487	12,206	1,954	3,773
Individuals	5,828	5,256	17	7	83	3	5,366	462	887
Commerce and services	2,629	1,023	139	-	78	247	1,487	1,142	1,853
Construction	303	232	-	-	21	14	267	36	19
Industrial and transportation	2,948	317	2,077	99	109	170	2,772	176	492
Investment companies	224	180	-	-	-	-	180	44	117
Public sector and non-profit organisations	53	37	-	-	-	-	37	16	1
Real estate	1,871	1,829	-	-	1	-	1,830	41	209
Seafood	304	129	49	-	36	53	267	37	195
Total	14,160	9,003	2,282	106	328	487	12,206	1,954	3,773

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49. Credit quality of financial assets

The following table provides the gross carrying amount of loans and credit risk exposure on loan commitments and financial guarantees. Amounts are broken down by risk class and the method by which their respective credit loss allowances (ECL) are calculated, i.e. Stage 1, 2 and 3.

The Group 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 Group uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Group 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.

Risk classes 1-4 represent low risk, risk classes 5-6 moderate risk, risk classes 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers that are in default. Unrated are loans originating from subsidiaries of Íslandsbanki that do not have rating models, in addition to loans that are yet to be rated.

Further information on the risk classes, including the mapping from risk classes to the probability of default, can be found in Section 4.2.2 of the unaudited Pillar 3 2019 Report.

The same customer can have loans and off-balance sheet commitments in Stages 1 and 2 simultaneously. However, if a customer has an exposure in Stage 3 then all other loans and commitments are classified as Stage 3 as well.

At 31 December 2019

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	226,347	289	-	226,636
Risk class 5-6	388,936	1,385	-	390,321
Risk class 7-8	204,979	14,487	-	219,466
Risk class 9	33,880	7,544	-	41,424
Risk class 10	-	-	27,160	27,160
Unrated	4,676	93	154	4,923
	858,818	23,798	27,314	909,930
Expected credit loss	(3,645)	(953)	(5,700)	(10,298)
Net carrying amount	855,173	22,845	21,614	899,632

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	58,327	25	-	58,352
Risk class 5-6	58,271	253	-	58,524
Risk class 7-8	15,334	1,757	-	17,091
Risk class 9	1,095	186	-	1,281
Risk class 10	-	-	1,233	1,233
Unrated	8	5	-	13
	133,035	2,226	1,233	136,494
Expected credit loss	(403)	(55)	(231)	(689)
Total	132,632	2,171	1,002	135,805

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At 31 December 2019	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	76,119	151,224	115,042	29,537	9,517	4,530	(2,824)	383,145
Commerce and services	29,718	81,536	31,572	3,968	6,810	383	(2,894)	151,093
Construction	3,354	33,345	17,924	1,120	5,468	-	(756)	60,455
Energy	5,045	3,846	2,004	-	-	-	(34)	10,861
Financial services	8,848	30	17	-	-	6	(7)	8,894
Industrial and transportation	26,474	59,108	11,775	2,363	3,526	-	(2,093)	101,153
Investment companies	2,803	9,198	11,090	1,367	268	1	(589)	24,138
Public sector and non-profit organisations	12,761	2,733	268	11	15	15	(30)	15,773
Real estate	52,934	64,623	42,304	3,631	2,400	-	(1,297)	164,595
Seafood	66,932	43,202	4,561	708	389	1	(463)	115,330
Total	284,988	448,845	236,557	42,705	28,393	4,936	(10,987)	1,035,437

At 31 December 2018

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	213,012	104	-	213,116
Risk class 5-6	367,843	1,055	-	368,898
Risk class 7-8	184,807	15,339	-	200,146
Risk class 9	38,633	12,363	-	50,996
Risk class 10	-	-	17,215	17,215
Unrated	4,137	41	95	4,273
	808,432	28,902	17,310	854,644
Expected credit loss	(3,277)	(1,079)	(3,689)	(8,045)
Net carrying amount	805,155	27,823	13,621	846,599

Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	68,712	30	-	68,742
Risk class 5-6	55,112	194	-	55,306
Risk class 7-8	16,913	1,899	-	18,812
Risk class 9	1,517	1,460	-	2,977
Risk class 10	-	-	623	623
Unrated	130	3	-	133
	142,384	3,586	623	146,593
Expected credit loss	(410)	(142)	(84)	(636)
Total	141,974	3,444	539	145,957

At 31 December 2018	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	74,325	135,721	101,859	33,354	6,955	3,499	(2,395)	353,318
Commerce and services	33,700	84,690	23,538	5,455	3,718	585	(2,771)	148,915
Construction	3,387	21,930	21,711	1,024	336	53	(643)	47,798
Energy	11,472	544	965	-	-	-	(32)	12,949
Financial services	9,450	419	8	-	-	4	(17)	9,864
Industrial and transportation	34,253	41,922	8,331	4,930	3,705	69	(973)	92,237
Investment companies	5,709	6,976	10,751	4,241	414	-	(475)	27,616
Public sector and non-profit organisations	13,150	3,119	240	-	52	66	(23)	16,604
Real estate	41,768	73,484	44,312	2,909	2,172	36	(946)	163,735
Seafood	54,644	55,399	7,243	2,060	486	94	(406)	119,520
Total	281,858	424,204	218,958	53,973	17,838	4,406	(8,681)	992,556

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50. Forbearance and write-offs

When restructuring or modification measures are believed to be more appropriate than collection procedures, the Group offers several debt relief measures and restructuring frameworks for customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants.

The relationship between forbearance and stages is discussed in Note 66.3.

Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for a loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:
- All of the customer's facilities have to be considered performing; and
- The customer does not have any contract that is more than 30 days past due; and
- The probation period of two years has passed from the date of the forbearance event; and
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period

The following table provides a summary of the Group's forborne assets.

At 31 December 2019	Stage 1	Stage 2	Stage 3	Total
Individuals	1,615	1,102	1,372	4,089
Companies	13,212	8,469	8,289	29,970
Gross carrying amount	14,827	9,571	9,661	34,059

	Stage 1	Stage 2	Stage 3	Total
Individuals	(12)	(41)	(182)	(235)
Companies	(77)	(249)	(2,167)	(2,493)
Expected credit loss	(89)	(290)	(2,349)	(2,728)

At 31 December 2018	Stage 1	Stage 2	Stage 3	Total
Individuals	1,741	2,020	1,238	4,999
Companies	14,377	2,016	4,588	20,981
Gross carrying amount	16,118	4,036	5,826	25,980

	Stage 1	Stage 2	Stage 3	Total
Individuals	(13)	(92)	(198)	(303)
Companies	(139)	(49)	(1,160)	(1,348)
Expected credit loss	(152)	(141)	(1,358)	(1,651)

Gross carrying amount written off and still subject to enforcement activity	2019	2018
Individuals	578	1,514
Companies	1,253	3,756
Total	1,831	5,270

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51. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

	31.12.2019	31.12.2018
Property and land	378	1,072
Industrial equipment and vehicles	81	41
Total	459	1,113

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations. The Group's employees are not permitted to purchase foreclosed assets.

52. Large exposures disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group'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 regulation no. 233/2017. The Group has internal criteria that define connections between clients. These criteria reflect the Group's interpretation of Article (1)(a) of the Act on Financial Undertakings no. 161/2002, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects. After mitigating effects, the Group currently has no large exposures, a decrease of four since the last reporting date. No large exposure is therefore above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects.

At 31 December 2019

Groups of connected clients:	Before	After
Group 1	75%	-

At 31 December 2018

Groups of connected clients:	Before	After
Group 1	73%	-
Group 2	12%	12%
Group 3	12%	11%
Group 4	11%	11%
Group 5	13%	11%

53. Liquidity risk

The Group 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.

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

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54. Liquidity coverage and Net stable funding ratio

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the Financial Supervisory Authority's guidelines no. 2/2010 on best practices in liquidity management and liquidity coverage ratio rules no. 266/2017.

The following tables show the NSFR and the LCR for the Group at year-end 2019 and 2018.

Net stable funding ratio	31.12.2019	31.12.2018
For all currencies	119%	114%
Foreign currencies	156%	149%

Liquidity coverage ratio	31.12.2019	31.12.2018
For all currencies	155%	172%
Foreign currencies	325%	544%

At 31 December 2019	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	157,080	157,080	31,858	31,858
Liquid assets level 2	11,942	6,271	3,727	520
Total liquid assets	169,022	163,351	35,585	32,378
Deposits	482,322	139,354	78,089	33,961
Debt issued	1,361	1,361	650	650
Other outflows	81,493	30,997	18,012	5,248
Total outflows	565,176	171,712	96,751	39,859
Short-term deposits with other banks**	54,203	52,335	51,343	50,261
Other inflows	33,984	14,213	6,287	3,558
Restrictions on inflows	-	-	-	(23,925)
Total inflows	88,187	66,548	57,630	29,894
Liquidity coverage ratio		155%		325%

At 31 December 2018	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	169,217	169,217	42,608	42,608
Liquid assets level 2	2,754	775	2,754	775
Total liquid assets	171,971	169,992	45,362	43,383
Deposits	455,883	127,018	67,513	25,191
Debt issued	875	875	875	875
Other outflows	72,598	32,095	15,277	5,849
Total outflows	529,356	159,988	83,665	31,915
Short-term deposits with other banks**	39,718	39,718	39,716	39,716
Other inflows	42,739	21,443	9,702	7,950
Restrictions on inflows	-	-	-	(23,730)
Total inflows	82,457	61,161	49,418	23,936
Liquidity coverage ratio		172%		544%

*Level 1 liquid assets include cash and balances with the Central Bank, domestic bonds eligible as collateral against borrowing at the Central Bank and foreign government bonds in accordance with rules no. 266/2017 on liquidity ratio.

**Short-tem deposits with other banks with maturity less than 30 days.

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Deposits by liquidity coverage ratio category

The Group's deposits are categorised by counterparty according to the Liquidity Coverage Ratio (LCR) standard. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classified as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme.

	Deposits maturing within 30 days					
At 31 December 2019	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	228,447	12%	83,773	5%	78,870	391,090
Operational relationships	2,446	25%	-	5%	-	2,446
Corporations	73,739	40%	337	20%	24,589	98,665
Sovereigns, Central Bank and public sector entities	6,813	40%	253	20%	620	7,686
Pension funds	35,405	100%	-	-	24,869	60,274
Domestic financial entities	28,494	100%	-	-	46,371	74,865
Foreign financial entities	8,038	100%	-	-	6,174	14,212
Total	383,382		84,363		181,493	649,238

	Deposits maturing within 30 days					
At 31 December 2018	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	216,428	12%	80,804	5%	78,476	375,708
Operational relationships	2,572	25%	-	5%	-	2,572
Corporations	63,887	40%	341	20%	22,809	87,037
Sovereigns, Central Bank and public sector entities	7,613	40%	246	20%	591	8,450
Pension funds	30,686	100%	-	-	26,987	57,673
Domestic financial entities	27,467	100%	-	-	24,622	52,089
Foreign financial entities	3,242	100%	-	-	7,807	11,049
Total	351,895		81,391		161,292	594,578

55. Maturity analysis of assets and liabilities

The following tables show the contractual payments of principal and interest for the Group'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.

Maturity analysis 31 December 2019

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Deposits from CB and credit institutions	30,925	1,992	16,363	8,468	4,580	-	-	31,403
Deposits from customers	618,313	453,959	78,232	54,994	16,612	62,222	-	666,019
Debt issued and other borrowed funds	306,381	-	6,991	24,861	267,776	90,610	-	390,238
Subordinated loans	22,674	-	158	463	2,865	26,482	-	29,968
Other financial liabilities:	24,772	17,581	2,124	1,276	1,759	2,448	-	25,188
Lease liabilities	4,256	-	116	349	1,759	2,448	-	4,672
Other liabilities	20,516	17,581	2,008	927	-	-	-	20,516
Total	1,003,065	473,532	103,868	90,062	293,592	181,762	-	1,142,816

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Off-balance sheet liabilities show the amount of contractual obligations that the Group 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 Group'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 Group 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	18,861	-	-	-	-	-	18,861
Undrawn loan commitments	35,443	-	-	-	-	-	35,443
Undrawn overdrafts	51,338	-	-	-	-	-	51,338
Credit card commitments	30,163	-	-	-	-	-	30,163
Total	135,805	-	-	-	-	-	135,805
Total non-derivative financial liabilities and off-balance sheet liabilities	609,337	103,868	90,062	293,592	181,762	-	1,278,621

The following table shows the contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative and a positive carrying amount at the reporting date. 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.

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	-	57,542	36,133	43,218	-	-	136,893
Outflow	-	(59,615)	(37,222)	(44,915)	-	-	(141,752)
Total	-	(2,073)	(1,089)	(1,697)	-	-	(4,859)
Net settled derivatives	-	(323)	-	-	-	-	(323)
Total	-	(2,396)	(1,089)	(1,697)	-	-	(5,182)

Maturity classification of assets is based on contractual maturity. 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	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	146,638	28,978	115,981	-	-	1,679	-	146,638
Loans to credit institutions	54,376	20,719	33,656	-	-	-	-	54,375
Bonds and debt instruments	52,870	7,768	23,998	10,120	10,983	-	-	52,869
Loans to customers	899,632	2,972	88,446	87,462	303,668	417,083	-	899,631
Shares and equity instruments	18,426	-	-	-	-	-	18,426	18,426
Other financial assets	5,757	1,889	525	118	17	-	3,259	5,808
Total	1,177,699	62,326	262,606	97,700	314,668	418,762	21,685	1,177,747

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	-	92,680	28,583	74,731	-	-	195,994
Outflow	-	(82,832)	(27,964)	(73,544)	-	-	(184,340)
Total	-	9,848	619	1,187	-	-	11,654
Net settled derivatives	-	273	-	-	-	-	273
Total	-	10,121	619	1,187	-	-	11,927

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The following tables show the comparative amounts for maturity analysis at year-end 2018.

Maturity analysis 31 December 2018

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Deposits from CB and credit institutions	15,619	4,594	3,229	4,992	3,249	-	-	16,064
Deposits from customers	578,959	420,242	81,178	37,952	26,976	38,070	-	604,418
Debt issued and other borrowed funds	300,976	404	24,214	21,178	154,315	141,098	-	341,209
Subordinated loans	16,216	-	90	307	2,242	20,417	-	23,056
Other financial liabilities	27,186	24,431	1,729	1,026	-	-	-	27,186
Total	938,956	449,671	110,440	65,455	186,782	199,585	-	1,011,933

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	18,021	-	-	-	-	-	18,021
Undrawn loan commitments	49,054	-	-	-	-	-	49,054
Undrawn overdrafts	49,833	-	-	-	-	-	49,833
Credit card commitments	29,049	-	-	-	-	-	29,049
Total	145,957	-	-	-	-	-	145,957
Total non-derivative financial liabilities and off-balance sheet liabilities	595,628	110,440	65,455	186,782	199,585	-	1,157,890

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	-	20,124	23,147	49,380	1,771	-	94,422
Outflow	-	(20,638)	(24,189)	(51,654)	(1,943)	-	(98,424)
Total	-	(514)	(1,042)	(2,274)	(172)	-	(4,002)
Net settled derivatives	-	(280)	-	-	-	-	(280)
Total	-	(794)	(1,042)	(2,274)	(172)	-	(4,282)

Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	135,056	47,746	87,310	-	-	-	-	135,056
Loans to credit institutions	41,577	24,152	17,425	-	-	-	-	41,577
Bonds and debt instruments	69,415	-	18,946	24,189	14,409	11,604	267	69,415
Loans to customers	846,599	2,054	90,269	74,716	282,624	396,936	-	846,599
Shares and equity instruments	13,074	-	-	-	-	-	13,074	13,074
Other financial assets	7,511	1,888	475	71	9	-	5,068	7,511
Total	1,113,232	75,840	214,425	98,976	297,042	408,540	18,409	1,113,232

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	-	57,050	22,267	77,126	327	-	156,770
Outflow	-	(56,077)	(21,929)	(74,072)	(343)	-	(152,421)
Total	-	973	338	3,054	(16)	-	4,349
Net settled derivatives	-	869	-	-	-	-	869
Total	-	1,842	338	3,054	(16)	-	5,218

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56. Market risk

The Group 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, foreign exchange rates, equity prices, CPI-indexation and commodity prices. Sources of market risk are imbalances in the Group's balance sheet and open positions in bonds, currencies and equities. Derivative contracts are also potential sources of market risk.

Market risk within the Group can broadly be split into two categories, trading book and banking book. The trading book includes market risk exposures related, directly or indirectly, to the Group's short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. 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. The banking book includes market risk exposures related to securities held for long-term investment purposes, unlisted securities or holdings in subsidiaries or affiliates. A large part of the banking book market risk is due to mismatches in the composition of assets and liabilities, for example with respect to currencies, interest rates, CPI-indexation or other factors that can affect the Group's earnings or earnings volatility. These mismatches are reported to management and are subject to internal and regulatory limits.

57. Interest rate risk

Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates. Sensitivity measures like Basis Point Value (BPV) are used 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.

Interest rate risk in the trading book

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing Financing Fund (HFF) which are guaranteed by the Icelandic Government, domestic municipality bonds, and covered bonds issued by other Icelandic banks. Bonds and bills in the Group's liquidity portfolio are also categorised in the trading book. In the following table the total market value (MV) of long and short positions may not be the same as reported in Note 5 since netting between short and long positions is not applied here.

	31.12.2019			31.12.2018		
Trading bonds and debt instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	1,143	6.84	(0.78)	1,872	6.13	(1.15)
Non-indexed	31,855	0.41	(1.29)	43,550	0.32	(1.40)
Total	32,998	0.63	(2.07)	45,422	0.56	(2.55)

	31.12.2019			31.12.2018		
Trading bonds and debt instruments, short positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	150	6.00	0.10	-	-	-
Non-indexed	615	4.00	0.28	198	5.00	0.09
Total	765	4.39	0.38	198	5.00	0.09
Net position of trading bonds and debt instruments	32,233	0.54	(1.69)	45,224	0.54	(2.46)

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The following table shows the interest rate sensitivity of the Group's trading book from a parallel 100 basis points change in all yield curves.

Sensitivity analysis for trading bonds and debt instuments

		31.12.2019		31.12.2018	
		Profit (loss)			
Currency	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	87	(87)	115	(115)
ISK, non-indexed	100	44	(44)	24	(24)
EUR	100	40	(40)	56	(56)
USD	100	32	(32)	29	(29)
Other total	100	9	(9)	-	-
Total		212	(212)	224	(224)

Interest rate risk in the banking book

Interest rate risk in the banking book arises from the Group'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 Group's assets and liabilities are of different maturities and are priced relative to different interest rates.

The following table shows the interest sensitivity of the Group's banking book from a parallel 100 basis points change in all yield curves, with all other variables held constant, categorised by the date of next interest rate reset.

Sensitivity analysis for interest rate risk in the banking book

At 31 December 2019

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	55	60	(442)	(1,668)	1,995	193	193
ISK, non-indexed	7	(12)	11	89	(10)	(9)	76
EUR	(17)	(20)	(29)	118	-	(2)	50
SEK	10	-	-	-	-	-	10
USD	(42)	-	-	-	-	(1)	(43)
Other	12	(11)	-	41	-	(6)	36
Total	25	17	(460)	(1,420)	1,985	175	322

At 31 December 2018

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	20	8	110	(3,318)	3,185	72	77
ISK, non-indexed	9	57	(7)	(193)	(77)	(1)	(212)
EUR	87	(25)	13	(1,605)	1,709	-	179
SEK	92	-	(16)	-	-	-	76
USD	(63)	-	-	-	-	-	(63)
Other	(1)	(11)	-	-	-	-	(12)
Total	144	29	100	(5,116)	4,817	71	45

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58. Currency risk

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 Group'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.

Currency analysis at 31 December 2019

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	942	319	210	52	24	51	73	114	58	123	1,966
Loans to credit institutions	11,689	25,740	1,650	378	534	116	9,707	1,294	272	687	52,067
Bonds and debt instruments	12,930	10,937	3	-	-	-	8,232	-	-	-	32,102
Loans to customers	112,185	29,486	2,037	581	3,185	3	3,408	635	6,005	33	157,558
Shares and equity instruments	31	3,371	419	-	-	-	27	-	-	-	3,848
Other assets	390	1,866	338	6	-	73	2	20	-	458	3,153
Total assets	138,167	71,719	4,657	1,017	3,743	243	21,449	2,063	6,335	1,301	250,694
Liabilities											
Deposits from credit institutions	9,145	558	1	-	-	-	-	-	-	-	9,704
Deposits from customers	32,247	27,939	3,810	385	395	874	3,317	3,617	453	42	73,079
Debt issued and other borrowed funds	91,809	-	-	-	-	37,768	19,565	-	-	-	149,142
Subordinated loans	-	-	-	-	-	22,674	-	-	-	-	22,674
Other liabilities	1,728	944	558	35	3	162	5	47	2	665	4,149
Total liabilities	134,929	29,441	4,369	420	398	61,478	22,887	3,664	455	707	258,748
Net on-balance sheet position	3,238	42,278	288	597	3,345	(61,235)	(1,438)	(1,601)	5,880	594	(8,054)
Net off-balance sheet position	(4,344)	(41,574)	(231)	(610)	(3,345)	61,127	1,255	1,726	(5,840)	(203)	7,961
Net position	(1,106)	704	57	(13)	-	(108)	(183)	125	40	391	(93)

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Currency analysis at 31 December 2018

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	377	250	135	23	10	54	51	88	29	73	1,090
Loans to credit institutions	15,662	12,614	4,488	258	613	4,683	1,901	530	123	538	41,410
Bonds and debt instruments	32,313	10,968	24	-	-	-	-	-	-	-	43,305
Loans to customers	105,852	31,603	2,037	734	3,213	2	4,318	572	5,710	39	154,080
Shares and equity instruments	45	2,202	398	-	-	-	40	-	-	-	2,685
Other assets	1,270	2,056	834	4	91	83	2	45	-	1,737	6,122
Total assets	155,519	59,693	7,916	1,019	3,927	4,822	6,312	1,235	5,862	2,387	248,692
Liabilities											
Deposits from credit institutions	5,622	538	83	-	96	-	16	-	-	-	6,355
Deposits from customers	26,605	26,819	4,293	329	430	927	3,211	1,728	434	144	64,920
Debt issued and other borrowed funds	113,670	-	-	-	-	41,764	-	-	-	-	155,434
Subordinated loans	-	-	-	-	-	16,216	-	-	-	-	16,216
Other liabilities	2,502	1,269	578	30	266	82	154	138	-	2,098	7,117
Total liabilities	148,399	28,626	4,954	359	792	58,989	3,381	1,866	434	2,242	250,042
Net on-balance sheet position	7,120	31,067	2,962	660	3,135	(54,167)	2,931	(631)	5,428	145	(1,350)
Net off-balance sheet position	(7,589)	(31,140)	(2,964)	(667)	(3,170)	54,350	(2,844)	642	(5,418)	(147)	1,053
Net position	(469)	(73)	(2)	(7)	(35)	183	87	11	10	(2)	(297)

Amounts are in ISK million

Notes to the Consolidated Financial Statements

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The following table shows the effect of a 10% depreciation or appreciation of foreign exchange rates where the Group had positions at the reporting date, with all other variables held constant.

Sensitivity analysis for currency risk	31.12.2019		31.12.2018	
	Profit or (loss)			
Currency	-10%	10%	-10%	10%
EUR	111	(111)	47	(47)
USD	(70)	70	7	(7)
GBP	(6)	6	-	-
CHF	1	(1)	1	(1)
JPY	-	-	4	(4)
SEK	11	(11)	(18)	18
NOK	18	(18)	(9)	9
DKK	(13)	13	(1)	1
CAD	(4)	4	(1)	1
Other foreign currencies	(39)	39	-	-
Total	9	(9)	30	(30)

59. Shares and equity instruments

The Group's equity exposure in the trading book arises from flow trading and market making with shares listed on the Nasdaq Iceland Stock Exchange. Shares and equity instruments in the banking book are classified as mandatorily at fair value through profit or loss or are classified as held for sale.

The following table shows how a 10% shift in equity prices would affect the Group's equity and net financial income. Securities used for hedging are excluded.

Sensitivity analysis for shares and equity instruments		31.12.2019		31.12.2018	
		Profit or (loss)			
Portfolio	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading book	10%	(169)	169	(123)	123
Banking book	10%	(806)	806	(639)	639
Total		(975)	975	(762)	762

60. Inflation risk

The Group is exposed to inflation risk since the value of CPI-linked assets exceeds CPI-linked 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 affect profit and loss. A 1% increase in the index would lead to an ISK 93 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

	31.12.2019	31.12.2018
Bonds and debt instruments	2,103	2,721
Loans to customers	295,725	293,917
Total CPI-linked assets	297,828	296,638

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	31.12.2019	31.12.2018
Deposits from customers	98,766	95,917
Debt issued and other borrowed funds	125,975	118,103
Off-balance sheet position	63,827	70,617
Total CPI-linked liabilities	288,568	284,637
CPI imbalance	9,260	12,001

61. Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. However, the Group is subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and collateral requirements. Other derivatives held for trading or for other purposes are insignificant.

62. Capital management

The following table shows the capital base, risk exposure amount, the resulting capital ratios, and leverage for the Group at 31 December 2019 and 31 December 2018.

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through Act no. 161/2002 on Financial Undertakings and regulation no. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

Article 501 of the capital requirements regulation (EU) no. 575/2013 of the European parliament came into effect in Iceland on 1 January 2020. This article stipulates capital requirements deduction for credit risk on exposures to SMEs and is expected to lower the risk exposure amount by ISK 15.6 billion, which corresponds to a 40 basis point increase in the Group's capital ratio.

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the Financial Supervisory Authority, applicable as of 30 September 2019, the overall capital requirement is 18.8%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The minimum leverage ratio for Icelandic financial institutions is 3%.

	31.12.2019	31.12.2018
CET1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	7,065	6,499
Retained earnings	105,569	102,496
Non-controlling interests	2,428	2,318
Fair value changes due to own credit standing	392	376
Tax assets	(476)	(215)
Intangible assets	(4,330)	(5,002)
Total CET1 capital	175,648	171,472
Tier 2 capital		
Qualifying subordinated liabilities	22,674	16,216
Total capital base	198,322	187,688

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	31.12.2019	31.12.2018
Risk exposure amount		
- due to credit risk	789,180	750,801
- due to market risk	7,919	7,622
Market risk, trading book	6,488	6,649
Currency risk	1,431	973
- due to credit valuation adjustment	2,027	2,385
- due to operational risk	85,424	85,141
Total risk exposure amount	884,550	845,949
Capital ratios		
Tier 1 ratio	19.9%	20.3%
Total capital ratio	22.4%	22.2%
Leverage ratio		
Exposure amount		
On-balance sheet exposures	1,189,062	1,120,637
Off-balance sheet exposures	38,849	47,119
Derivative exposures	9,461	8,935
Leverage ratio total exposure measure	1,237,372	1,176,691
Tier 1 capital	175,648	171,472
Leverage ratio	14.2%	14.6%

63. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Goup's definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board has approved an Operational Risk Policy which outlines the Bank's framework for operational risk management. Risk Management is responsible for implementing the Bank's operational risk framework, for developing, maintaining the Operational Risk Policy and for communicating the policy to the Bank's employees.

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Accounting policies

64. Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, short positions in listed bonds, derivative financial instruments and certain bonds. Non-current assets and disposal groups held for sale are measured at the lower of its carrying amount and fair value less costs to sell. Recognised financial liabilities designated as hedged items in qualifying fair value hedge relationships are measured at amortised cost adjusted for changes in fair value attributable to the risk being hedged.

65. Changes in presentation

The Group has changed its presentation in the statement of financial position as follows:
- The line item "Non-current assets and disposal groups held for sale" has been included in the line item "Other assets"
- The line item "Non-current liabilities and disposal groups held for sale" has been included in the line item "Other liabilities"

66. Significant accounting policies

The accounting policies set out below have been applied consistently by the Group to the periods presented in these consolidated financial statements.

At 1 January 2019 the Group implemented IFRS 16 - Leases and elected not to restate comparative period information. Accordingly, comparative periods are presented in accordance with IAS 17 - Leases, as described in the Group's audited consolidated financial statements for the year ended 31 December 2018.

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66.1 Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries presented as those of a single economic entity. The Group consolidates its subsidiaries on the basis of control whereas subsidiaries are entities controlled by the Group.

Control

Subsidiaries are investments that the Group has control over. The Group controls an investment when the Group is exposed, or has rights, to variable returns from its involvement with the investment and has the ability to affect those returns through its power over the investment. The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities and the ability to exercise its right.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

When the Group assesses whether it controls an entity, it also determines whether it is a principal or an agent. If the Group has the power to direct the activities of the entity to generate returns for itself, then it is a principal. If the Group is primarily engaged to act on behalf and for the benefit of other parties, then it is an agent and it does not control the entity when exercising its decision-making rights delegated to it. In assessing whether the Group is a principal or an agent it considers the overall relationship between itself, the entity and other parties involved with the entity. In particular, the Group considers the scope of its decision-making authority over the entity, the rights held by other parties, the remuneration to which it is entitled in accordance with any remuneration agreements and the Group's exposure to variability of returns from other interests that it holds in the entity. Different weightings are applied to each of these factors on the basis of particular facts and circumstances.

The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to one or more of the elements of control.

Funds management

The Group acts as a manager for Undertakings for Collective Investment in Transferable Securities (UCITS) and investment funds as well as other funds for collective investment that accept capital from investors. Such funds are financed by issuing unit share certificates or shares. The Group does not have any contractual financial responsibility with respect to such custom units. The funds are not consolidated unless they are under the control of the Group.

The Group reviews all the facts and circumstances in order to decide if these funds should be consolidated. The Group is deemed to be a principal and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or guarantee, and is able to influence the returns of the funds by exercising its power.

Consolidation

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group loses control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities are eliminated in full on consolidation. The carrying amount of Íslandsbanki's investment in each subsidiary and Íslandsbanki's portion of equity of each subsidiary are eliminated and any related goodwill is recognised as an asset.

If the Group loses control of a subsidiary, it derecognises the related assets (including goodwill), liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss in the line item "Other operating income". Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

When the Group is committed to a sale plan involving the loss of control of a subsidiary and the criteria for classification as held for sale are met (see Note 66.11), it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements. This is regardless of whether the Group will retain a non-controlling interest in the subsidiary after the sale. The gain or loss from the sale is recognised in profit or loss in the line item "Profit (loss) from discontinued operations, net of income tax".

66.1 Cont'd

Non-controlling interests

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination, the Group measures at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instruments' proportionate share in the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by the International Financial Reporting Standards.

The Group presents non-controlling interests within equity in the statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki and to non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

When the proportion of the equity held by non-controlling interests changes, the Group adjusts the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to equity holders of Íslandsbanki hf. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

Business combinations and goodwill

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

66.2 Foreign currencies

The financial statements of each of the Group's entities are measured using the functional currency of the respective entity.

On initial recognition transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. At the end of each reporting period monetary assets and liabilities denominated in foreign currencies are retranslated into functional currencies using the closing rate. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the functional currency using the exchange rate at the date when the fair value was determined.

Foreign currency differences arising on retranslation from one currency to another are recognised in profit or loss (see Note 66.19).

66.3 Financial assets and financial liabilities

Recognition

The Group recognises a financial asset and a financial liability in its statement of financial position on the trade date, which is the date on which the Group becomes party to the contractual provisions of the instrument, except for loans which are recognised on the date when cash is advanced by the Group to the borrowers. At initial recognition, the Group measures a financial asset or a financial liability at its fair value plus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability.

Derecognition

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

The Group derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

66.3 Cont'd

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

The Group does not derecognise from its statement of financial position securities which the Group sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Modifications

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value.

Classification and measurement of financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories (see also Note 5):

• Financial assets at amortised cost
• Financial assets at fair value through other comprehensive income
• Financial assets at fair value through profit or loss
• Derivative assets held for hedging

The measurement basis of individual financial assets is determined based on an assessment of the cash flow characteristics of the assets and the business models under which they are managed.

The business models

The business models are determined by the Group's key management personnel in the way that assets are managed and their performance is reported to them. The Group determines its business models at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. This condition is not an instrument-by-instrument approach to classification, but is determined at a higher level of aggregation. The Group's business models fall into the following three categories: Held to collect, Held to collect and for sale, and Other fair value business models, where assets are held for trading or managed on a fair value basis and are neither Held to collect nor Held to collect and for sale.

Solely payments of principal and interest (SPPI)

Financial assets held within the business models Held to collect and Held to collect and for sale, are assessed to evaluate if their contractual cash flows are comprised of solely payments of principal and interest. SPPI payments are those which are consistent with a basic lending arrangement. Principal is the fair value of the financial asset at initial recognition and changes over the life of the financial asset, for example if there are repayments of principal. Interest relates to basic lending returns, including compensation for the time value of money and credit risk associated with the principal amount outstanding over a period of time. Interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs), as well as a profit margin that is consistent with a basic lending arrangement.

Where the contractual terms introduce exposure to risk or variability of cash flows that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

Financial assets at amortised cost

A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows, i.e. Held to collect.

Financial assets at amortised cost are measured using the effective interest method. Amortised cost is calculated by taking into account the amount at which the assets are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment. Accrued interest is included in the carrying amount of the financial asset in the statement of financial position. Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

66.3 Cont'd

Financial assets at fair value through other comprehensive income (FVOCI)

For shares and equity instruments that are not held for trading, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. This election is made on an instrument-by-instrument basis. Shares and equity instruments at FVOCI are not subject to an impairment assessment. Dividends are to be presented in profit or loss, as long as they represent a return on investment. On derecognition there is no recycling of fair value gains and losses to profit or loss.

Financial assets at fair value through profit or loss (FVTPL)

Financial assets classified at fair value through profit or loss are all other financial assets which are not classified at amortised cost or at fair value through other comprehensive income. This includes financial assets classified mandatorily at fair value through profit or loss and financial assets which are irrevocably designated by the Group at initial recognition as at fair value through profit or loss that would otherwise meet the requirements to be measured at amortised cost or at FVOCI. The Group designates financial assets as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise. During the year the Group did not classify any financial assets as designated at fair value through profit or loss.

Financial assets at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned, which is recognised in the line item "Interest income" and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)".

Derivative assets held for hedging

Derivative assets held for hedging consist of derivatives with positive fair value which are designated and accounted for as hedging instruments (see Note 66.5).

Classification and measurement of financial liabilities

For the purpose of measuring its financial liabilities, the Group classifies them at inception in one of the following categories (see also Note 5), except for loan commitments and financial guarantees (see Note 66.12):

- Financial liabilities at amortised cost
- Financial liabilities mandatorily at fair value through profit or loss
- Financial liabilities designated as at fair value through profit or loss
- Derivative liabilities held for hedging

Financial liabilities at amortised cost

Financial liabilities at amortised cost are non-derivative financial liabilities. Financial liabilities at amortised cost include deposits, debt issued and other borrowed funds, and subordinated loans.

Financial liabilities at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums and fees and costs that are an integral part of the effective interest rate). Accrued interest is included in the carrying amount of the liabilities in the statement of financial position.

The amortised cost of certain bonds issued by the Group, which are designated as hedged items in qualifying fair value hedge relationships, is adjusted for changes in the fair value of the bonds attributable to interest rate risk (see Note 66.5).

Financial liabilities mandatorily at fair value through profit or loss

Financial liabilities mandatorily at fair value through profit or loss are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities mandatorily at fair value through profit or loss consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities mandatorily at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

66.3 Cont'd

Financial liabilities designated as at fair value through profit or loss

Financial liabilities designated as at fair value through profit or loss are recognised at fair value and changes in fair value attributable to changes in the credit risk of those liabilities are recognised in other comprehensive income and are not subsequently reclassified to profit or loss. The remaining fair value changes are included in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" using the effective interest rate method and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

The Group calculates the fair value attributable to changes in credit risk as the difference between the changes in fair value of the financial liability and the amount of changes in fair value attributable to changes in market interest rates. The change in fair value attributable to changes in market interest rates on financial liabilities is calculated by discounting contractual cash flows at the end of the period with the discount rate of the appropriate market interest rate.

Upon initial recognition, the Group determines if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, if applicable the whole fair value change is presented in profit or loss.

Derivative liabilities held for hedging

Derivative liabilities held for hedging consist of derivatives with negative fair value which are designated and accounted for as hedging instruments (see Note 66.5).

Reclassification

Financial assets are reclassified between measurement categories if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the Group's operations.

Financial liabilities are not reclassified.

Determination of fair value

The fair value of a financial instrument is the transaction price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the reporting date.

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which observable market prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate.

Periodically, the Group tests the valuation techniques and calibrates against historical data and using prices from observable current market transactions for the same instrument, or based on other available observable market data.

Changes in the fair value of financial assets and financial liabilities are recognised in profit or loss in the line item "Net financial income (expense)".

The Group has an established control framework with respect to the measurement of fair values. The business unit owning the positions is responsible for their valuations and for submitting the valuation to the Bank's Investment Committee for approval. Risk Management provides an independent review of the results, the valuation methods used and of the use of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's Investment Committee.

Impairment of financial assets

The impairment model of IFRS 9 is forward-looking and impairment under IFRS 9 should reflect a probability weighted average of possible outcomes. In addition, the expected credit loss model in IFRS 9 employs a dual measurement approach, under which the loss allowance for expected credit losses (ECL) is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk (SICR) of the financial instrument since initial recognition. To satisfy the provisions of the IFRS 9 standard, a significant amount of modelling must be involved. The models which the Group uses for the calculation of the impairment amount are developed according to the Group's modelling framework. This framework imposes structure on the initial model development work, the model documentation including educational material as needed for users, the approval process for models, the implementation of models and the lifetime support for models, including validation and back-testing. The Group's impairment process, which encompasses all the steps needed to derive the appropriate impairment allowance for each accounting period, is documented and approved by the All Risk Committee.

66.3 Cont'd

Stage assignment
At each reporting date, all assets subject to the impairment methodology must be divided into three groups, termed "Stages", reflecting the extent of credit deterioration since initial recognition. This division then has an effect on how the impairment is measured and how interest is recognised.

Stage 1
All assets that have not experienced an SICR are assigned to Stage 1. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from credit events occurring within 12 months of the reporting date (12- month ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 2
Assets that the Group determines to have experienced an SICR, but are not credit-impaired, are classified as Stage 2. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from all credit events occurring within the expected lifetime of the assets (lifetime ECL). Interest is recognised on the gross carrying amount of the assets.

The Group's definition of an SICR is on the level of an individual asset. The Group assesses that there has been a significant increase in credit risk of an asset if the probability of a credit impairment event, i.e. transfer to Stage 3, occurring over the lifetime of the asset has increased significantly from the origination of the assets. For this purpose, origination does not refer to any modification events which have not resulted in derecognition of the asset. The assessment is based on a defined set of triggers. This includes, as a backstop, the trigger that the asset is more than thirty days past due. Other triggers are internal assessments of outlook, events such as forbearance events which are less severe than a credit event, external credit related information and a significant deterioration in risk assessment compared with the risk assessment done in relation to the origination of the asset. The definition of SICR depends only on the probability of a credit event occurring, it does not take into account collateralisation or any other information related to the expected loss arising from the event. As soon as all triggers for Stage 2 for a particular asset are no longer activated then the asset moves back to Stage 1. Additionally, assets are classed as forborne for two years after a forbearance event has occurred, but forbearance events only cause assets to be in Stage 2 for six months and then they migrate back to Stage 1 unless other triggers apply.

The Group does not employ the low credit risk exemption in the Stage assignment process. In alignment with its operating procedures, the Group has chosen as its accounting policy to measure the impairment allowance for lease receivables at an amount equal to the lifetime ECL only for those assets which have an SICR or are credit-impaired. For other lease receivables the impairment allowance is equal to the 12-month ECL.

Stage 3
This Stage is for assets which are credit-impaired according to the Group's assessment. These assets are therefore experiencing an ongoing credit event. Thus, the 12-month ECL and lifetime ECL are the same amount and this amount is recognised as impairment allowance. For assets in this Stage, interest is recognised on the carrying amount of assets, i.e. net of impairment allowance.

The Group's definition of being credit-impaired is on a customer level, rather than on the level of an individual asset. According to the definition, a customer is credit-impaired when either of the following holds:
a) The Group assesses that it is unlikely that the customer can service all of their commitments to the Group in accordance with the terms of the agreements without recourse to default provisions in the agreements, or
b) The customer is more than 90 days past due on any of their commitments

The assessment in point a) is made based on a defined set of triggers, which includes serious breach of covenants, serious registrations on an internal watchlist, initiation of serious collection actions and serious external credit related information.

Furthermore, there is a defined set of conditions which must be satisfied so that customers that have been assessed as being credit-impaired are no longer subject to this assessment. This includes probation periods and a view to the future outlook of the customer.

Expected credit loss (ECL)
The ECL for each asset is calculated using models for the probability of a credit impairment event occurring (PD), the loss percentage expected in case of such an event (LGD) and the outstanding amount at the time of the event (EAD). In its simplest form the ECL can be calculated as the product of these factors, however, for several reasons, the actual formula must be more complicated than this.

The Group uses the standardised approach for regulatory capital purposes but has used PD models and LGD models for risk management purposes for several years. These models have been adapted for IFRS 9 purposes. For EAD, and for LGD to a certain extent, new models have been developed.

66.3 Cont'd

The PD models are either fully automated statistical models, expert models or hybrid. For the models with a component involving expert input there is a process in place to ensure proper review of the model outcome and periodic reassessment of obligors. The inputs into the models include demographic variables, information from financial statements and past payment behaviour, among other variables.

The effects of the economy on the PD is accounted for with the use of scaling factors which map through-the-cycle PD values to point-in-time PD values. The Group has a model to predict these scaling factors based on an economic forecast. The economic forecast is provided by the Group's Chief Economist. The forecast predicts a range of macroeconomic indicators over a horizon of five years. The model is applied to a subset of these indicators and produces a set of scaling factors. The scaling factors are then reviewed by the All Risk Committee with respect to all of the indicators and any other relevant information available and the committee approves their use for the calculation of the impairment. This process is carried out at least quarterly. The Group uses three economic scenarios. In addition to the base forecast, scaling factors are produced for a bull and bear case. This is done in order to represent the whole range of possible future economic developments. The actual impairment allowance is the weighted average of the ECL in these different scenarios.

The table below shows macroeconomic indicators of the Group's Chief Economist's macroeconomic forecast

Change in economic indicators %	2019	2020	2021	2022	2023
Economic growth	(0.1)	1.3	2.8	2.5	2.5
Housing prices in Iceland	3.1	2.8	3.3	3.5	3.5
Purchasing power	1.8	1.9	2.4	2.1	2.2
ISK exchange rate index	8.8	0.3	-	-	-
Policy rate, Central Bank of Iceland	3.9	3.3	3.7	4.0	4.0
Inflation	3.1	2.6	2.8	2.6	2.5
Capital formation	(6.5)	5.7	4.5	4.1	4.1
thereof capital formation in industry	(16.5)	5.5	4.0	4.5	4.5

The LGD model considers several scenarios for how a facility may develop once a credit event has occurred. One possibility is that the facility cures without a loss. If not, the recoveries may be based on the seizing of collateral and to estimate such recoveries, several scenarios for the development of the value of the collateral are considered. Finally, there may be recoveries even though a formal collateral is not in place. These different recovery scenarios are weighted differently depending on the economic scenario under consideration. This leads to a non-linear interaction and thus a difference between the probability weighted average ECL and the ECL in the most likely scenario.

For EAD it is necessary to account for expected prepayments on term loans and for the expected utilisation of commitments such as credit cards, overdrafts, financial guarantees and credit lines. The expected lifetime of agreements may also extend beyond the contractual lifetime for contracts which are generally extended.

Write-off policy
The Group writes off a financial asset, either partially or in full, when there is no realistic prospect of recovery. Where financial assets are secured, write-off is generally after receipt of any proceeds from the realisation of security. In subsequent periods, any recoveries of amounts previously written off are credited to the income statement.

The impairment process
In the Group's impairment framework, the Stage assignment and ECL for each financial asset is calculated from the aforementioned models. The outcome is reviewed by the business units and they can propose changes if they provide sufficient supporting material. The impairment and any proposals for changes are reviewed by an Impairment Council appointed by the All Risk Committee and the impairment allowance is approved by the All Risk Committee on a quarterly basis.

The principle of materiality applies to the above discussion on impairment, whereby exceptions related to non-materiality and immaterial adjustments are not discussed.

66.4 Derivative financial instruments

Derivatives are primarily used in trading activities but are also used to manage the Group's exposure to various risks, such as interest rate risk, inflation risk and currency risk. Derivatives which do not classify as equity instruments of the Group are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities).

The Group applies hedge accounting. Accordingly, some of the Group's derivative financial assets and financial liabilities are accounted for as financial assets or financial liabilities mandatorily at fair value through profit or loss while others are accounted for as derivative assets or liabilities held for hedging (see Note 66.3 and Note 66.5).

When derivatives are embedded in other financial instruments or host contracts, such combinations are known as hybrid instruments with the effect that some of the cash flows of a hybrid instrument vary in a way similar to a stand-alone derivative. These embedded derivatives are measured and presented in the consolidated financial statements as if they were free-standing derivatives. The Group accounts for an embedded derivative separately from the host contract when, the host contract is not an asset in the scope of IFRS 9, is not carried at fair value through profit or loss, the terms of the embedded derivative would meet the definition of a derivative if they were contained in a separate contract, and the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract. When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

66.5 Fair value hedge accounting

The Group applies fair value hedge accounting with respect to designated hedging relationships consisting of certain fixed-rate euro denominated bonds as the hedged items and certain euro denominated interest rate swaps as the hedging instruments, whereby the Group pays floating rate interest and receives fixed rate interest. The hedging relationships are designated and accounted for as fair value hedges because the interest rate swaps are hedging the exposure of the Group to changes in the fair value of the bonds arising from changes in interest rates. The Group recognises the changes in the fair value of the interest rate swaps immediately in profit or loss together with the changes in the fair value of the bonds which are attributable to the interest rate risk. The changes in the clean fair value of the swaps and the notes are included in the line item “Net financial income (expense)”, the accrued interest on the notes and the swaps is included in the line item “Interest expense” and foreign exchange gains and losses on the notes are included in the line item "Net foreign exchange gain (loss)".

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80-125%.

If a hedging derivative expires or is sold, terminated or exercised, or a hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting for the corresponding hedging relationship is discontinued prospectively. Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

66.6 Cash and cash equivalents

Cash and cash equivalents in the statement of cash flows consist of cash on hand, demand and term deposits with the Central Bank, demand deposits with credit institutions, and short-term loans to credit institutions. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, that are subject to an insignificant risk of changes in their fair value and which are used by the Group in the management of its short-term cash commitments. Cash and cash equivalents are carried at amortised cost in the statement of financial position and at the reporting date the expected credit loss is considered to be low. Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

66.7 Investments in associates

Associates are entities over which the Group has significant influence to participate in the financial and operating policy decisions of an entity, but has not control over those policies. It is presumed that the Group has significant influence if the Group holds 20-50% of the voting power of an entity.

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. After the acquisition date the carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets. Distributions received from an associate reduce the carrying amount of the investment. Goodwill relating to acquisitions of associates is included in the carrying amount of the investments and is not tested for impairment separately.

66.7 Cont'd

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases.

When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and the impairment loss is recognised in profit or loss.

Upon loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

Income and expenses from investments in associates are recognised in profit or loss in the line item "Other operating income".

66.8 Property and equipment

Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses (see Note 66.21). Where parts of an item of property and equipment have different useful lives, those components are accounted for and depreciated as separate items of property and equipment.

Subsequent costs

The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred, if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in profit or loss as incurred.

Depreciation

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. The depreciable amount of each item of property and equipment is determined after deducting its residual value. Depreciation is recognised in profit or loss in the line item "Other operating expenses" on a straight-line basis over the estimated useful lives of each part of an item of property and equipment.

Right-of-use assets are included in the line item "Property and equipment" (see Note 66.10).

The estimated useful lives are as follows:

Buildings	50 years
Right-of-use assets	3-31 years
Fixtures	6-12 years
Equipment	4-5 years
Vehicles	3 years

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

66.9 Intangible assets

Software

Software acquired by the Group is measured at cost less accumulated amortisation and impairment losses. Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is carried at capitalised cost less accumulated amortisation and impairment losses.

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred. Software is amortised on a straight-line basis over its estimated useful live from the date that it is available for use. The amortisation is recognised in profit or loss in the line item "Other operating expenses". The estimated useful life of software is four to ten years.

66.9 Cont'd

Goodwill

The Group recognises any goodwill arising from a business combination as an asset and measures it initially at cost, being the positive difference between (a) the aggregate of the consideration transferred, the amount of any non-controlling interest and the acquisition-date fair value of the Group's previously held equity interest in the acquiree and (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed by the Group. After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is tested by the Group for impairment annually or whenever there is an indication that it may be impaired.

66.10 Leases

The Group as a lessee

At the inception of a contract, the Group assesses whether a contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration. The Group has elected not to separate non-lease components and account for lease and non-lease components of a contract as a single lease component.

The Group recognises a lease liability and a right-of-use asset at the lease commencement date. The Group has elected not to recognise right-of-use assets and lease liabilities for short-term leases that have a lease term of 12 months or less and leases of low-value assets. The Group recognises lease payments associated with these leases as an expense on a straight-line basis over the lease term.

Lease liabilities

The lease liability is initially measured at the present value of the lease payments, both fixed and variable, discounted using the entity's incremental borrowing rate. The incremental borrowing rate is the rate of interest the Group would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment. The incremental borrowing rate is subject to estimation when no observable rates are available. The lease liability is measured at amortised cost using the effective interest method and remeasured when there is a change in future payments, e.g. arising from a change in an index or an assessment of whether extension or termination options will be exercised. After the commencement date, the amount of lease liabilities is increased to reflect the accretion of interest and reduced for the lease payments made.

The lease term is determined by the Group as the non-cancellable term of the lease, together with any periods covered by an option to extend the lease if it is reasonably certain to be exercised, or any periods covered by an option to terminate the lease, if it is reasonably certain not to be exercised. An assessment of whether the entity will exercise an extension or termination option is made by management annually. If the assessment of whether the Group will exercise an extension or termination option changes after the commencement date the lease liability is remeasured and a corresponding adjustment is made to the carrying amount of the right-of-use asset.

Right-of-use assets

The right-of-use asset is initially measured at cost, which comprises the initial amount of the lease liability adjusted for any lease payments made at or before the commencement date, plus any initial direct costs incurred less any lease incentives received. For any remeasurement of the lease liability a corresponding adjustment is made to the carrying amount of the right-of-use asset or recorded in profit or loss if the carrying amount of the right-of-use asset has been reduced to zero. The right-of-use-asset is subsequently depreciated using the straight-line method from the commencement date to the end of the lease term. Right-of-use assets are subject to impairment.

If a lease modification increases the scope of the lease by adding a right to use of one or more underlying assets and the consideration for the lease increases by an amount commensurate with the stand-alone price for the increased scope and any adjustments to the price that reflects the circumstances of the particular contract, then the modification is accounted for as a separate lease. For lease modifications that are not accounted for as separate leases the lease term of the modified lease is redetermined and the lease liability remeasured using the revised lease payments and discounted using the incremental borrowing rate at the effective date of modification. Any adjustment of the lease liability is then correspondingly made to the right-of-use asset.

The Group presents right-of-use assets in the line item "Property and equipment" and lease liabilities in the line item "Other liabilities" in the statement of financial position. Maturity analysis of lease liabilities is disclosed in Note 55. Interest on lease liabilities is recognised in profit or loss in the line item "Interest expense". Depreciation of right-of-use assets is recognised in profit or loss in the line item "Other operating expenses".

66.10 Cont'd

The Group as a lessor

The Group classifies leases based on the substance of the arrangements and the extent of the transfer of risks and rewards incidental to ownership of the leased asset. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

When the Group is the lessor in a capital lease, the Group recognises a receivable equal to the net investment in the lease and presents it in the line item "Loans to customers" in the statement of financial position. The Group applies its accounting policies for derecognition and impairment of financial assets also to its capital lease receivables. The Group recognises the finance income from capital lease receivables in profit or loss in the line item "Interest revenue" over the period of the capital lease so as to give a constant periodic rate of return on the net investment in the capital lease.

When the Group is lessor in arrangements which involve the legal form of capital leases, but which in substance do not involve leases, the Group classifies them within loans at amortised cost.

66.11 Non-current assets and disposal groups held for sale

Non-current assets and disposal groups are classified as held for sale if the Group expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable. Non-current assets and disposal groups are presented in the line item "Other assets" and Non-current liabilities and disposal groups are presented in the line item "Other liabilities".

Immediately before the initial classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable accounting policies. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets and financial assets, which are measured in accordance with the accounting policies of the Group applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment are no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Group applicable to those liabilities.

Income and expenses of non-current assets and disposal groups held for sale are recognised in profit or loss in the line item "Discontinued operations, net of income tax" (see Note 66.23).

66.12 Loan commitments and financial guarantees

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. Expected credit loss of loan commitments (see Note 66.3) is recognised in the statement of financial position in the line item "Other liabilities". Loan commitment fees received by the Group are recognised in profit or loss in the line item "Fee and commission income".

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities.

Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received. Subsequently the liabilities are carried at the higher of the amount representing the initial fair value of the guarantee and the expected credit loss allowance of the guarantee (see Note 66.3). Any changes in the liabilities arising from financial guarantees are recognised in profit or loss. The premium received is recognised in profit or loss in the line item "Fee and commission income".

66.13 Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group will be required to settle the obligation with an outflow of resources, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the reporting date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that the reimbursement will be received and the amount of the receivable can be measured reliably.

66.14 Employee benefits

All Group entities are required to pay, on a mandatory and contractual basis, contributions to public and private pension funds. The Group has no further payment obligations once these contributions have been paid. The Group recognises these contributions as salary related expenses when they become due. The Group does not have a defined benefit pension plan.

Short-term employee benefits include salaries, cash bonuses, non-monetary benefits and compensated absences. Short-term employee benefit obligations are expensed by the Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

66.15 Equity

Share capital

The share capital disclosed in the consolidated financial statements represents the total nominal value of ordinary shares issued by the Bank. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

Dividends on shares

Dividends payable to shareholders of the Bank are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders at the Bank's Annual General meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

Statutory reserve

According to the Act on Public Limited Companies no. 2/1995 the statutory reserve shall amount to 25% of the share capital of the Bank.

Restricted reserves

The Group is to transfer, if applicable, certain amounts from retained earnings to restricted reserves which can therefore not be distributed as dividends to shareholders. These restricted reserves are specified as follows:

Restricted reserve due to capitalised development costs

When the Group capitalises development cost it transfers a corresponding amount from retained earnings to a restricted reserve. In the future the restricted amount is to be transferred back to retained earnings as the capitalised development cost is amortised in profit or loss.

Restricted reserve due to fair value changes of financial assets

The Group transfers fair value changes of financial assets at fair value through profit or loss, net of tax if applicable, from retained earnings to a restricted reserve. Amounts recognised in the reserve are transferred back to retained earnings upon sale of the financial asset.

Restricted reserve due to unrealised profit of subsidiaries and associates

If share of profit of a subsidiary or an associated company is in excess of dividend received or which can be claimed, the Group transfers the difference to a restricted reserve in equity. If the Group's shareholding in a subsidiary or an associate is sold or written off the applicable amount recognised in the reserve is transferred to retained earnings.

Fair value reserve

Fair value reserve comprises all unrealised gains or losses related to fair value changes of equity instruments classified at fair value through other comprehensive income. On derecognition of the equity instruments fair value changes are not reclassified to profit and loss.

Liability credit reserve

Changes in fair value attributable to changes in the credit risk of financial liabilities designated as at fair value through profit or loss are recognised in liability credit reserve. On derecognition the fair value changes are not reclassified to profit or loss.

66.16 Interest income and interest expense

For all financial assets and financial liabilities measured at amortised cost, interest income and interest expense are recognised in profit or loss using the effective interest method.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate. The change in carrying amount is recorded as interest income or interest expense. For floating rate instruments, interest income or interest expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset. For financial assets in Stage 1 and Stage 2 interest is recognised on the gross carrying amount of the assets and for financial assets in Stage 3 interest is recognised on the gross carrying amount of the assets, net of impairment allowance (see Note 66.3).

Interest income and interest expense include gains and losses on derecognition of financial assets and financial liabilities measured at amortised cost.

For financial assets and financial liabilities at fair value through profit and loss, interest income and interest expense are recognised through profit or loss on an accrual basis, except for financial liabilities at fair value through profit or loss (see Note 66.3).

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro denominated bonds issued by the Group (see Note 66.5), is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

66.17 Net fee and commission income

Fees and commissions are recognised to reflect the transfer of services to customers at an amount that reflects the consideration that is expected to be received for such services. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Fees for loan commitments that are likely to be utilised are recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to be utilised, fees are recognised in profit or loss on a straight-line basis over the commitment period.

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities, or the purchase or sale of businesses, are recognised on completion of the underlying transaction.

Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria are fulfilled.

Where it is assessed that the Group is acting as an agent, the consideration is presented on a net basis.

66.18 Net financial income (expense)

Net financial income (expense) consists of net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss, net gain (loss) on financial liabilities designated as at fair value through profit or loss and net gain (loss) on fair value hedges.

66.18 Cont'd

Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss
Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets and financial liabilities classified by the Group as mandatorily at fair value through profit or loss, except for interest income and interest expense, which are included in the line items "Interest income" and "Interest expense", and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)". Dividend income from financial assets is recognised in the income statement when the Group's right to receive payment is established.

Net gain (loss) on financial liabilities designated as at fair value through profit or loss
Net gain (loss) on financial liabilities designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial liabilities designated by the Group as at fair value through profit or loss, except for changes in fair value attributable to changes in credit risk which is recognised in other comprehensive income, interest incurred which is recognised as "Interest expense" using the effective interest rate method, and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Net gain (loss) on fair value hedges

Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are designated and accounted for as hedging instruments in fair value hedges and the changes in the fair value of certain bonds issued by the Group, which are attributable to the interest rate risk of the bonds (see Note 66.5).

66.19 Net foreign exchange gain (loss)

Net foreign exchange gain (loss) disclosed as a separate line item in the income statement comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous financial statements. Net foreign exchange gain (loss) also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured by the Group at fair value in foreign currencies.

66.20 Operating expenses

Operating expenses consist of professional services, information system related expenses, housing expenses, depreciation of property and equipment, amortisation of intangible assets and other operating expenses, such as advertising expenses, office expenses and various public expenses.

66.21 Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the Group estimates the recoverable amount of the asset.

An impairment loss is recognised in profit or loss if the carrying amount of an asset or cash-generating unit exceeds its estimated recoverable amount.

An impairment loss for non-financial assets is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised. An impairment loss in respect of goodwill is never reversed.

66.22 Taxes

Income tax expense
Income tax expense comprises special financial activities tax, current tax and deferred tax and is disclosed as a separate line item in the income statement. Income tax expense from discontinued operations is included in the income statement in the line item "Profit (loss) from discontinued operations, net of income tax" (see Note 66.23). Income tax is recognised in profit or loss, except to the extent that it relates to items recognised directly in equity, consistent with the recognition of the underlying item to which it relates.

Bank tax
Bank tax is calculated as 0.376% (2018: 0.376%) of total liabilities at year-end as determined for tax purposes, in excess of ISK 50,000 million, excluding tax liabilities. The Bank tax is considered a non-deductible expense for the calculation of income tax. The Bank tax is shown in a separate line in the income statement and is included in the statement of financial position in the line item "Tax liabilities".

66.22 Cont'd

Special financial activities tax

Special financial activities tax is calculated as 6% of taxable profit exceeding ISK 1,000 million. Special financial activities tax is included in the statement of financial position in the line item "Tax liabilities".

Current tax

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Current tax is included in the statement of financial position in the line item "Tax liabilities".

Deferred tax

Deferred tax is recognised based on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred taxes are not recognised if it arises from the initial recognition of an asset or liability, in a transaction other than a business combination, that at the time of the transaction affects neither the taxable profit nor the accounting profit. In addition, deferred taxes are not recognised if the temporary difference arises from the initial recognition of goodwill.

Deferred tax is measured using tax rates enacted or substantially enacted at the reporting date and are expected to apply when the deferred tax asset is realised or the deferred tax liability is settled.

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

Deferred tax liabilities are included in the statement of financial position in the line item "Tax liabilities" and deferred tax assets are included in the statement of financial position in the line item "Other assets". Deferred taxes that are part of discontinued operations (see Note 66.11) are included in the line items "Other assets" and "Other liabilities", respectively, in the statement of financial position.

Deferred tax assets and deferred tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred taxes relate to taxes levied by the same taxation authority on either, the same taxable entity, or on different taxable entities which intend to settle the taxes on a net basis or their tax assets and liabilities will be realised simultaneously.

66.23 Discontinued operations, net of income tax

Discontinued operations, net of income tax, are disclosed as a separate line item in the income statement and consist of (i) the post-tax profit or loss from foreclosed assets and disposal groups held for sale, (ii) gain or loss recognised on the measurement to fair value less costs to sell in excess of book value of foreclosed assets, and (iii) profit or loss from sale of foreclosed assets and disposal groups held for sale.

66.24 Offsetting

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

The Group presents income and expenses on a net basis in the income statement only when required or permitted by the accounting standards.

66.25 Earnings per share

The Group presents basic and diluted earnings per share for its ordinary shares. Basic earnings per share are calculated by dividing the profit or loss attributable to ordinary shareholders of the Bank by the weighted average number of ordinary shares outstanding during the period. Diluted earnings per share are determined by adjusting the profit or loss attributable to ordinary shareholders of the Bank and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

66.26 Segment reporting

An operating segment is a distinguishable component of the Group, for which discrete financial information is available, that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segment is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. The segments' operating result are reported to the Board of Directors and the Chief Executive Officer, for the purpose of resource allocation and assessment of segment performance.

Íslandsbanki

Consolidated Financial Statements 2018

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Directors' Report

The audited consolidated financial statements of Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) for the financial year 2018 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Group".

Operations in 2018

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share. The vision is to make Íslandsbanki #1 for service and for six years in a row our customers have been the most satisfied in the country, according to the Icelandic Customer Satisfaction Index.

The profit from the Group's operations for the reporting period amounted to ISK 10,645 million, which corresponds to 6.1% return on equity. The Board of Directors proposes that ISK 5.3 billion will be paid in dividends to shareholders. The Board may convene a special shareholders' meeting later in the year to propose payment of additional dividends if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements. In 2018, the Bank paid ISK 13 billion in dividends to the Bank's shareholders. At the end of the reporting period, the Group employed 1,075 full-time members of staff, including 834 within the Bank itself, 62% female and 38% male.

Net interest income increased by 6.5% between years, as strong balance sheet growth was somewhat offset by a lower interest rate environment. Net fee and commission income dropped by 11.1%, where growth in the Bank was offset by reduced activity in two of the subsidiaries of the Bank. Other net operating income was ISK 823 million, being positively impacted by the sale of one of the Bank's subsidiaries, while net financial income was negative by ISK 962 million, due to losses in mark-to-market of derivative hedges and losses on equity trading. Administrative expenses were up by 2.5% between years. Salary costs were up by 1.8% between years, as a result of reduced capitalisation of salaries in 2018, due to an investment in the Bank's core banking systems, and collective wage increases, somewhat offset by a reduction in full time equivalents' (FTE's) in the Bank. Net impairments were positive by ISK 1,584 million as the loan book continued to perform well on the back of a strong economy and a release of a provision as the statue of limitation for some disputed foreign currency-linked loan contracts passed.

The balance sheet of the Group grew by 9.1% between years on the back of a 12.1% growth in loans to customers. Loan book growth was especially strong in the first half of the year and slowed somewhat down in the second half and especially in the fourth quarter. Using the European Banking Authority's definition of non performing loans (NPL's), which does not only include loans to customers but also loans and advances to central banks and credit institutions, the Bank's NPL ratio was 1.7% at the end of 2018, compared to 3.4% average for European banks. The average LTV for mortgages decreased from 63% to 61%. Deposits from customers increased by 2.1% during the course of 2018, where an increase in deposits from individuals and SMEs was offset by a reduction in deposits from large corporates. The Bank's funding cost levels in the international capital markets deteriorated during 2018, as global market volatility increased and investors became more risk adverse. The Bank was however successful in its capital market funding operations, with issuance in line with the Bank's plans and a well received Tier 2 bond issuance in the third quarter of the year. The Bank's ratings were affirmed by both S&P (BBB+) and Fitch (BBB) with a stable outlook.

The Group's total equity amounted to ISK 176.3 billion and total assets were ISK 1,130.4 billion at the end of the reporting period and the Group's total capital ratio was 22.2%. At the end of September, the Group was presented with the results of the annual SREP process conducted by the Icelandic Financial Supervisory Authority. The results included the updated capital requirement for the Group. The total regulatory capital requirement is now 18.8% of the risk exposure amount, down from 19.8% the year before. The decrease in the capital requirement is due to a reduction in the Group's market risk profile. However, the Icelandic Financial Stability Council announced in May that the countercyclical buffer will increase by 50 basis points, from 1.25% to 1.75%, as of May 2019, which will then bring the total regulatory capital requirement up to 19.3%. Based on the updated SREP results, the Board of the Bank approved an updated capital target. The new target entails a management buffer of 0.5-2.0% on top of the SREP requirement, where the upper limit has been raised from 1.5% to provide management with more flexibility in its capital management. The updated overall capital target is therefore 19.3-20.8%, from the previous target of 20.3-21.3%, and will become 19.8-21.3% with the higher countercyclical buffer from May 2019 onwards. The Bank's liquidity position remains strong and well above regulatory requirements.

The Bank made considerable changes to its organisational structure in the second quarter of 2017. Three income-generating divisions now serve customers: Personal Banking, Business Banking, and Corporate & Investment Banking. These changes are now represented in these financial statements, as can be seen in Note 5.

In September, the Bank launched its new core banking system for deposits and payments. This is a major milestone operationally, as this has been the Bank's largest infrastructure project in recent times. Overall, the implementation was successful, with limited negative impact on the Bank's customers. The Bank also introduced several new digital solutions for its customers during the year, including a safe online live chat service, the first of its kind in Iceland and offered the option to use mobile phones and smart watches to pay for goods and services.

Directors' Report

Outlook

After seeing a very strong growth in recent years, the Bank's Chief economist is expecting 1.1% growth in 2019 and 3.1% in 2020. Investment levels are expected to remain close to 20% of GDP, where increased new construction of residential housing will offset a reduction in business investments. Consumer confidence has dropped considerably in recent quarters, after having peaked in 2016, and private consumption is therefore expected to show slow growth in the near term. Inflation was measured at 3.7% in 2018 and is expected to be a similar levels in 2019 and then coming down to 3.2% in 2020. At the same time, the current account surplus is expected to be around 3% of GDP in 2019, a similar level as was seen in 2018, and Iceland's net investment position and the Central Bank's foreign reserves are at very healthy levels.

The Bank remains in a very strong position, with a robust balance sheet and very healthy capital and liquidity levels in both the domestic krona and foreign currencies. Profitability has come down from the very high levels seen in recent years and achieving the 8-10% target ROE range will be a key challenge going forward. As economic growth recedes, growth in the loan book growth is expected to moderate, requiring stronger management focus to enhance profitability. The Bank will continue to invest in its IT infrastructure and digital solutions and thereby meet new requirements in the regulatory environment and enhance the customer experience.

Risk management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations and the Bank has focused on building up a responsible internal risk culture among the Bank's employees. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies and the CEO is responsible for ensuring that risks are managed within those limits.

The Bank's risk management framework and policies are discussed under Notes 47-69 to the consolidated financial statements and in the unaudited Pillar 3 Report.

Ownership

Íslandsbanki is, and was during the year 2018, fully owned by the Icelandic State Treasury, directly (99.9%) and through its subsidiary ISB Holding ehf. (0.1%). The shares are administered by the Icelandic State Financial Investments (ISFI – Bankasýsla ríkisins) on its behalf.

Corporate governance

The Board of Directors of Íslandsbanki is committed to excellence in its governance framework so that it complies with the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as “Exemplary in Corporate Governance” in March 2014 by the Center of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in 2015, 2016, 2017 and 2018.

The Board of Directors comprises seven non-executive directors and two alternates. The Board undertakes the Bank's affairs and is responsible for setting the Bank's general strategy as well as instructing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with relevant laws, regulations and good business practices. Furthermore, the Board shall monitor the execution of its policies, the sound control of accounting and financial management, and ensure that group internal audit, compliance, risk management and internal controls are effective at all times.

Candidates for board membership are nominated through a selection process administered by the Icelandic State Financial Investments (ISFI) in accordance with Article 7 of the ISFI Act no. 88/2009. At the Bank's Annual General Meeting in March the Board of Directors was elected for the Bank. No changes were made to the Board members. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board consists of seven members, four female and three male. The Board has approved a policy on the suitability of the Board of Directors, the CEO and key function holders. The policy states, among other things, that the composition of the Board shall at any time be diversed, with regard to educational and professional background, gender and age.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of Board subcommittees are available on the Bank's website.

Directors' Report

The CEO is responsible for the day-to-day operations of the Bank and that the Bank's business is, at all times, in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Committee and other Senior Management Committees.

The Executive Committee, comprising seven members, including the CEO, is composed of four women and three men. The role of the Executive Committee is to maintain an overall view of the Bank's operations and to coordinate key aspects of its activities that are not supervised by other senior management committees. The CEO ensures that the Board is regularly provided with accurate information on the Bank's finances, development and operations.

The Bank's Finance division is responsible for the preparation of the Bank's consolidated financial statements in line with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review the second quarter interim consolidated financial statements and audit annual consolidated financial statements.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to its operations, including those imposed by the FME, Central Bank of Iceland and Nasdaq Iceland. The applicable laws include, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Public Limited Companies no. 2/1995 and the Act on Competition no. 44/2005, available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is (hereinafter the Guidelines). The Bank's practices are compliant with the guidelines except for Article 1.5.

Article 1.5 of the Guidelines provides that the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by ISFI in accordance with article 7 of the ISFI Act.

A more detailed description of Íslandsbanki's governance framework and associated practices can be found in the Bank's Corporate Governance Statement enclosed in an unaudited Appendix to the consolidated financial statements and on the Bank's website, www.islandsbanki.is.

Corporate social responsibility

Íslandsbanki adheres to a policy on corporate social responsibility with the aim to have a positive effect on society. Since 2010 Íslandsbanki has adhered to the UN Global Compact on social responsibility and annually publishes a social responsibility report on corporate social responsibility based on the UN Global Compact. The social responsibility report examines the policy and progress of projects that relate to corporate social responsibility.

As a signatory to the UN Global compact Íslandsbanki is committed to aligning its operations and strategies with 10 principles covering human rights, labour, the environment and anti-corruption. The Bank has in place a Code of Conduct and a Conflict of Interest Policy in order to ensure creditability in business transacted by the Bank and its clients and employees' impartiality in handling and processing individual cases.

Íslandsbanki supports the international relief work by the Red Cross by participating in the *Digital Divide Initiative* where the Red Cross and the Red Crescent work in more than ten African countries to improve knowledge and equipment in information technology. Íslandsbanki supports the initiative by providing both specialists in information technology to act as ambassadors as well as providing funds. Íslandsbanki's employees have already been on several diplomatic trips to Africa.

Last year Íslandsbanki joined the Nordic CEOs for a Sustainable Future, a group of some of the Nordic region’s largest listed companies that have committed to work together to speed up the realisation of the United Nation's Sustainable Development Goals (SDGs). Among the group are the CEOs of Equinor, Hydro, GSMA, Íslandsbanki, Nokia, SAS, Swedbank, Telenor Group, Telia Company, Vestas and Yara International. The CEOs have a common commitment to speak for the need for new business models to drive sustainable development.

For the fourth consecutive year Íslandsbanki held an equality meeting on the development of the gender ratio in different sectors. More than two thousand people have attended Íslandsbanki's meetings on gender equality and even more have watched them online.

Directors' Report

In the wake of the #metoo debate the Bank made a decision to go over all processes in place and make sure that members of staff knew how to report gender discrimination. The CEO and the executive directors met with about 150 members of staff in small group settings where the #metoo topic was discussed openly.

The Bank's social responsibility efforts are further described in the unaudited Annual Report.

Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2018 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable, to the extent that they are not inconsistent with the requirements of the IFRS as adopted by the EU.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2018 and its financial position as of 31 December 2018. The financial statements and the Director's report give fair view of the main operational developments and achievements and accurately describe the risks and uncertainties that the Group faces in its operations.

The Board of Directors and the CEO have today discussed and approved the 2018 Consolidated Financial Statements of Íslandsbanki.

Kópavogur, 13 February 2019

Board of Directors:

Friðrik Sophusson, Chairman
Helga Valfells, Vice-Chairman
Anna Þórðardóttir
Auður Finnbogadóttir
Árni Stefánsson
Hallgrímur Snorrason
Heiðrún Jónsdóttir

Chief Executive Officer:

Birna Einarsdóttir

Building a better working world

Independent Auditor's Report

To the Board of Directors and shareholders of Íslandsbanki hf.

Opinion

We have audited the consolidated financial statements of Íslandsbanki hf. and it subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2018 and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended, in accordance with the International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

Basis for Opinion

We conducted our audit in accordance with the International Standards on Auditing (ISAs). Our responsibilities are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the consolidated financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key Audit Matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Why significant	How our audit addressed the Key Audit Matter
Provision for credit impairment	

As described in Notes 2, 3 and 72.3, the provision for credit impairment is determined in accordance with International Financial Reporting Standard 9, Financial Instruments (IFRS 9). The new standard was implemented by the Group on 1 January 2018, replacing the former standard, IAS 39.
 	
IFRS 9 required considerable judgement and interpretation in its implementation. The new standard also introduced fundamental changes to the provision process, models and governance. The implementation of IFRS 9 and subsequent provisions for credit impairment was therefore considered a Key Audit Matter.
 	
Loans to customers represent ISK 846.599 million or 75% of total assets at 31 December 2018 against which impairment allowances of ISK 8.045 million have been recorded.
 	
Key areas of judgement included:
• the interpretation of the requirements to determine impairment under application of IFRS 9, which is reflected in the Group's expected credit loss model;
• the identification of loans with significant deterioration in credit quality;
• assumptions used in the expected credit loss model such as the financial condition of the counterparty, expected future cash flows and forward-looking macroeconomic factors as disclosed in Notes 2 and 72.3.
	Our audit procedures relating to the provision for credit impairment were conducted with the support of internal specialists. We assessed the IFRS 9 framework implemented by the Group, including the models developed and the inputs and assumptions applied. Our procedures focused on the following to respond to the Key Audit Matter, among others:
	
	• Assessed the Group's expected credit loss model, in particular focusing on the following areas:
	  ◦ alignment of the expected credit loss model and its underlying methodology with the requirements of IFRS 9; and
	  ◦ approach to the incorporation of forward-looking macroeconomic factors.
	• Tested the effectiveness of relevant controls relating, among others, to the:
	  ◦ data used to determine the provision for credit impairment, including transactional data captured at loan origination and ongoing internal credit quality assessment;
	  ◦ expected credit loss model, including model build and approval, ongoing monitoring/validation, model governance and mathematical accuracy;
	  ◦ registration and valuation of collateral used in the calculation of expected credit loss;
	• We examined a sample of loans and performed procedures to evaluate the:
	  ◦ timely identification of loans with significant deterioration in credit quality; and

- expected loss calculation by re-performing and assessing the reasonableness of the ECL model calculations.

In addition, we assessed the adequacy of the disclosures in the consolidated Financial Statements.

Why significant	How our audit addressed the Key Audit Matter
Reliability of information from IT systems	
The Group is highly dependent on IT systems due to the significant number of transactions that are processed daily and the complexity of the various systems used by the Group. As described in the Director´s Report on page 3, the Group also implemented a new deposits and payments system during the year. The implementation was on a large scale and affected various IT systems and processes within the Group increasing the risk of errors in data produced by the systems. In the process of preparing the consolidated Financial Statements the Group uses information from many systems and is dependent on the accuracy and completeness of information drawn from the systems. Because of the above we consider the accuracy and completeness of information generated by the IT systems a Key Audit Matter.	Our procedures focused on the following to respond to the Key Audit Matter, among others: • Using our internal IT specialists, we gained an understanding of the IT processes within the Group. • Based on that understanding and prior years' experience we selected the systems most important for the preparation of the consolidated Financial Statements. For those, we inspected the appropriateness of employees' access. • Recalculating interest income and expense calculations in the systems for selected dates during the year. • Comparing information from the systems with external data sources, such as currency exchange rates and consumer price index. • Recalculating reports generated by the systems. We performed specific procedures to address the implementation of the new system with a focus on the following, among others: • Gaining an understanding of the implementation process of the new system and discussing the implementation status and risks with management during the year. • Testing reconciliation of the new system and other systems at year end. • Inspecting reconciliation of the general ledger accounts used in the implementation and discussion about the process with employees responsible for the reconciliations. • Selecting a sample of transactions processed in the implementation and confirming our understanding and the nature of the transactions. • Assessed the work performed by the internal auditor in relation to the implementation. For a material outsourced system, we relied on an ISAE 3402 report provided by the service provider.

Other information in the Annual Report of Íslandsbanki hf. for the year 2018

Other information consists of the information included in Íslandsbanki´s 2018 Annual Report other than the consolidated financial statements and our auditor's report thereon. Management and Board of Directors are responsible for the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed on the other information obtained prior to the date of the auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of CEO and Board of Directors for the consolidated Financial Statements

The Chief Executive Officer (CEO) and Board of Directors are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

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

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors is responsible for overseeing the Group's consolidated financial reporting process.

Auditor's Responsibilities for the Audit of the consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with the International Standards on Auditing (ISAs), we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the Key Audit Matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on the Board of Directors report

Pursuant to the legal requirements of Article 104, Paragraph 2 of the Icelandic Financial Statement Act no. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the consolidated financial statements includes all information required by the Icelandic Financial Statement Act.

Reykjavík, 13 February 2019

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Margrét Pétursdóttir
State Authorised Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Consolidated Income Statement

	Notes	2018	2017
Interest income*		61,675	56,767
Interest expense		(29,738)	(26,768)
Net interest income	11	31,937	29,999
Fee and commission income		19,853	20,855
Fee and commission expense		(7,626)	(7,105)
Net fee and commission income	12	12,227	13,750
Net financial expense	13	(962)	(715)
Net foreign exchange gain	14	1	527
Other operating income	15	1,784	628
Other net operating income		823	440
Total operating income		44,987	44,189
Salaries and related expenses	16	(15,500)	(15,233)
Other operating expenses	17	(12,150)	(11,735)
Contribution to the Depositors' and Investors' Guarantee Fund		(1,173)	(1,083)
Bank tax	72.22	(3,281)	(2,892)
Total operating expenses		(32,104)	(30,943)
Profit before net impairment on financial assets		12,883	13,246
Net impairment on financial assets	19	1,584	1,556
Profit before tax		14,467	14,802
Income tax expense	20	(4,734)	(4,151)
Profit for the year from continuing operations		9,733	10,651
Profit from discontinued operations, net of income tax	21	912	2,575
Profit for the year		10,645	13,226

*Of which interest income amounting to ISK 59,741 million is calculated using the effective interest method.

Profit attributable to:			
Shareholders of Íslandsbanki hf.		11,036	13,577
Non-controlling interests		(391)	(351)
Profit for the year		10,645	13,226

Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	22	1.01	1.10

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 11 Amounts are in ISK million

Consolidated Statement of Comprehensive Income

	2018	2017
Profit for the year	10,645	13,226
Items that are or will be reclassified to profit or loss		
Foreign currency translation differences for foreign operations	-	9
Items that will not be reclassified to profit or loss		
Changes in fair value of financial assets and financial liabilities, net of tax	1,730	415
Other comprehensive income for the year, net of tax	1,730	424
Total comprehensive income for the year	12,375	13,650

Total comprehensive income attributable to:		
Shareholders of Íslandsbanki hf.	12,542	13,864
Non-controlling interests	(167)	(214)
Total comprehensive income for the year	12,375	13,650

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 12 Amounts are in ISK million

Consolidated Statement of Financial Position

	Notes	31.12.2018	31.12.2017
Assets			
Cash and balances with Central Bank	23	135,056	189,045
Bonds and debt instruments	6	69,415	27,090
Shares and equity instruments	6	13,074	10,177
Derivatives	24	4,550	2,896
Loans to credit institutions	25	41,577	26,617
Loans to customers	26	846,599	755,175
Investments in associates	28	682	704
Property and equipment	30	5,271	7,128
Intangible assets	31	5,002	4,231
Other assets	32	7,947	9,993
Non-current assets and disposal groups held for sale	33	1,230	2,766
Total Assets		1,130,403	1,035,822
Liabilities			
Deposits from Central Bank and credit institutions	34	15,619	11,189
Deposits from customers	35	578,959	567,029
Derivative instruments and short positions	24	5,521	5,492
Debt issued and other borrowed funds	37	300,976	217,748
Subordinated loans	38	16,216	9,505
Tax liabilities	40	7,150	7,787
Other liabilities	41	29,643	35,947
Non-current liabilities and disposal groups held for sale	33	6	80
Total Liabilities		954,090	854,777
Equity			
Share capital		10,000	10,000
Share premium		55,000	55,000
Reserves		6,499	6,179
Retained earnings		102,496	107,387
Total equity attributable to the equity holders of Íslandsbanki hf.		173,995	178,566
Non-controlling interests		2,318	2,479
Total Equity		176,313	181,045
Total Liabilities and Equity		1,130,403	1,035,822

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 13 Amounts are in ISK million

Consolidated Statement of Changes in Equity

	Share capital	Share premium	Restricted reserves	Fair value reserve	Liability credit reserve	Other reserves	Retained earnings	Total shareholders' equity	Non-controlling interests	Total equity
Equity as at 1.1.2017	10,000	55,000	1,673	(25)	-	2,491	105,563	174,702	4,223	178,925
Profit for the year							13,577	13,577	(351)	13,226
Dividends paid							(10,000)	(10,000)	(1,717)	(11,717)
Net change in fair value of AFS financial assets				264				264	151	415
Translation differences for foreign operations						9	14	23	(14)	9
Changes in non-controlling interests								-	187	187
Restricted due to capitalised development cost			1,312				(1,312)	-		-
Restricted due to fair value changes			266				(266)	-		-
Restricted due to subsidiaries and associates			189				(189)	-		-
Equity as at 31.12.2017	10,000	55,000	3,440	239	-	2,500	107,387	178,566	2,479	181,045
Impact of adopting IFRS 9, see Note 3					(1,486)		(2,530)	(4,016)	6	(4,010)
Impact of adopting IFRS 15, see Note 3							(97)	(97)		(97)
Equity as at 1.1.2018	10,000	55,000	3,440	239	(1,486)	2,500	104,760	174,453	2,485	176,938
Profit for the year							11,036	11,036	(391)	10,645
Dividends paid							(13,000)	(13,000)		(13,000)
Net change in fair value of financial assets				386				386	224	610
Net change in fair value of financial liabilities					1,110		10	1,120		1,120
Restricted due to capitalised development cost			458				(458)	-		-
Restricted due to fair value changes			123				(123)	-		-
Restricted due to subsidiaries and associates			(271)				271	-		-
Equity as at 31.12.2018	10,000	55,000	3,750	625	(376)	2,500	102,496	173,995	2,318	176,313

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2018 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank. The Bank has one class of ordinary shares which carry no right to fixed income. The Annual General Meeting ("AGM") for the operating year 2017 was held on 22 March 2018. At the AGM shareholders approved the Board's proposal to pay dividends to shareholders amounting to ISK 13,000 million which is equivalent to ISK 1.30 per share (2017: ISK 1.00 per share). The dividends were paid on 28 March 2018.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 14 Amounts are in ISK million

Consolidated Statement of Cash Flows

	Notes	2018	2017
Profit for the year		10,645	13,226
Non-cash items included in profit for the year		16,061	10,766
Changes in operating assets and liabilities		(120,407)	(65,743)
Dividends received		55	41
Income tax and bank tax paid		(7,873)	(7,806)
Net cash used in operating activities		(101,519)	(49,516)
Net investment in subsidiaries and associated companies		4,764	(36)
Proceeds from sale of property and equipment		15	9
Purchase of property and equipment	30	(611)	(1,386)
Purchase of intangible assets	31	(877)	(1,803)
Net cash provided by (used in) investing activities		3,291	(3,216)
Proceeds from borrowings		115,661	56,287
Repayment of borrowings		(48,475)	(51,652)
Dividends paid		(13,000)	(2,449)
Dividends paid non-controlling interests		-	(2,148)
Net cash provided by financing activities		54,186	38
Net decrease in cash and cash equivalents		(44,042)	(52,694)
Effects of foreign exchange rate changes		(193)	(131)
Cash and cash equivalents at the beginning of the year		187,438	240,263
Cash and cash equivalents at year-end		143,203	187,438

Reconciliation of cash and cash equivalents

	Notes	2018	2017
Cash on hand	23	3,095	1,976
Cash balances with Central Bank	23	131,961	187,069
Bank accounts	25	25,259	15,959
Mandatory reserve and special restricted balances with Central Bank	23	(17,112)	(17,566)
Cash and cash equivalents at year-end		143,203	187,438

The Group has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year.

Interest received in 2018 was ISK 58,354 million (2017: ISK 59,168 million) and interest paid in 2018 was ISK 24,386 million (2017: ISK 23,922 million). Interest paid 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 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 15 Amounts are in ISK million

Consolidated Statement of Cash Flows

	2018	2017
Depreciation and impairment	801	778
Amortisation of intangible assets	511	244
Share of gain of associates	(29)	(82)
Accrued interest and fair value changes on debt issued and subordinated loans	10,436	7,731
Net impairment on financial assets	(1,634)	(1,556)
Foreign exchange (gain)	(1)	(527)
Net gain on sale of subsidiary, property and equipment	(1,557)	(285)
Unrealised fair value loss (gain) recognised in profit or loss	406	(5)
Net profit on non-current assets classified as held for sale	(912)	(2,575)
Bank tax	3,281	2,892
Income tax	4,734	4,151
Other changes	25	-
Non-cash items included in profit for the year	16,061	10,766

Mandatory reserve and special restricted balances with Central Bank	454	29,627
Loans to credit institutions	767	(5,613)
Loans to customers	(82,808)	(63,120)
Trading assets	(41,151)	(29)
Other operating assets	2,611	(2,811)
Non-current assets and liabilities held for sale	770	3,429
Deposits with credit institutions and Central Bank	4,116	6,095
Deposits from customers	4,307	(26,127)
Trading financial liabilities	(270)	(205)
Derivatives	(2,491)	(44)
Other operating liabilities	(6,712)	(6,945)
Changes in operating assets and liabilities	(120,407)	(65,743)

Non-cash transactions 2018

During the year the Bank repurchased own debt securities amounting to ISK 184 million by issuing new debt.

Non-cash transactions 2017

a) The Bank paid dividends amounting to ISK 10,000 million. Thereof are non-cash transactions amounting to ISK 7,551 million which were paid with a government bond.

b) The Bank's debt securities of ISK 12,083 million were paid during the period by issuing bonds. The transaction had no cash effect on the Group.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

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Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. Corporate information

Íslandsbanki hf. the parent company was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The consolidated financial statements for the year ended 31 December 2018 comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

At the end of 2018 the Bank was wholly owned by the Icelandic Government, directly and through its subsidiary ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Group provides a wide range of financial services such as retail banking, corporate banking, investment banking, wealth management and asset financing. The Group operates mainly in the Icelandic market.

2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 13 February 2019.

On 1 January 2018 the Group implemented IFRS 9 - Financial Instruments and IFRS 15 - Revenue from Contracts with Customers. The impact of the implementation of IFRS 9 and IFRS 15 on the opening balance sheet at 1 January 2018 is disclosed in Note 3.

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, these consolidated financial statements have been prepared on a going concern basis.

These consolidated financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At year-end the exchange rate of the ISK against the USD was 116.33 and 133.23 for the EUR (2017: USD 104.42 and EUR 125.05).

Important accounting estimates and judgements

The preparation of the 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. Actual results may differ from those estimates.

Estimates and underlying assumptions are under constant review. Changes in accounting estimates are recognised when they occur.

Impairment of financial assets

Effective from 1 January 2018 the Group has applied IFRS 9 - Financial Instruments and the related amendments to the other IFRSs in accordance with the transition provisions set out in IFRS 9.
The main assumptions used for calculating the allowance for credit losses that are subject to significant judgement include the following:

- Probability of default (PD), loss given default (LGD) and exposure at default (EAD)
- Macroeconomic variables for multiple scenarios build on available information
- Assessment of significant increase in credit risk

The probability of default (PD), exposure at default (EAD), and loss given default (LGD) inputs used to estimate expected credit losses are modelled based on variables that are most closely related with credit losses in the relevant portfolio. This includes macroeconomic variables, demographic variables, variables related to past payment history among other variables. These variables are sourced both internally and externally.

The allowance for credit losses is further discussed in Notes 26-27, in Notes 50-52 on risk management and in Note 72.3.

Fair value of financial instruments

The fair value of financial instruments where an active market or quoted prices are not available are decided upon by using estimation procedures. The valuation methods are discussed in Notes 7-8 and in Note 72.3.

Intangible assets

Intangible assets, except for goodwill, are amortised over four to ten years. Intangible assets are reviewed at each reporting date to determine whether there is any indication of impairment. The value in use method is used by the Group to determine the recoverable amount of intangible assets. Intangible assets are further discussed in Note 31 and in Note 72.9.

3. Changes to accounting policies

The new IFRS standards and amendments to standards which became effective from 1 January 2018 did not have a material impact on the Group's consolidated financial statements, except for changes to IFRS 9. Those changes are described below.

IFRS 9 – Financial Instruments

The Group adopted a new IFRS standard, IFRS 9 – Financial Instruments, which replaced IAS 39 as of 1 January 2018. As a result of the application of IFRS 9, the Group changed its accounting policies. The most significant changes were made to the accounting of impairment, classification and measurement of financial assets and financial liabilities. These new accounting policies were applicable from 1 January 2018 and are described in Note 72.3. Adjustments to carrying amounts of financial assets and financial liabilities at the date of initial application were recognised in equity as of 1 January 2018.

As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative period information; accordingly, all comparative period information is presented in accordance with previous accounting policies, as described in the Group's audited consolidated financial statements for the year ended 31 December 2017. New or amended disclosures have been provided for the current year, where applicable, and comparative period disclosures are consistent with those made in the prior year.

The Group has elected to continue to apply the hedge accounting principles under IAS 39 instead of those under IFRS 9. The policy for hedge accounting is described in Note 72.5.

Impact of adoption of IFRS 9

The IFRS 9 transition reduced shareholders' equity by ISK 4,010 million in total net of tax at 1 January 2018, thereof ISK 2,484 million is due to changes in impairments and ISK 1,526 million due to reclassification of debt securities. The CET1 capital ratio reduced by 25 basis points.

In addition to IFRS 9 the Group implemented IFRS 15 which does not have a material impact on the consolidated financial statements.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 – Revenue from contracts with customers became effective on 1 January 2018 and replaced various IFRS standards and interpretations on revenue recognition related to sale of goods and services. IFRS 15 establishes a single comprehensive framework for accounting for revenue arising from sale of goods and services through contracts which fall under its scope. IFRS 15 does not apply to revenue arising from financial instruments but it applies to fees charged by the Group which are not part of the effective interest rate of a financial instrument.

The Group adopted IFRS 15 by applying the cumulative effect method, under which the effect of initial adoption was recognised in equity on 1 January 2018 and comparative information was not restated. The Group recognised ISK 97.4 million as a decrease in retained earnings at 1 January 2018 due to the adoption of IFRS 15. This change is due to the change in revenue recognition for insurance broker commissions, whereas the transaction price now reflects a refund liability due to contractual provisions in the contract with the insurance provider, which is the principal in the transaction, and a related refund asset due to commissions paid by the Group to sale agents. Apart from this change the adoption of IFRS 15 did not result in changes to the timing or amount of revenue recognition.

As a result of the application of IFRS 15, the Group changed the presentation in the consolidated income statement as described in Note 71.

3. Cont'd

Transition of financial assets and financial liabilities

The following table summarises the day one impact of the implementation of IFRS 9 showing the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities.

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At 1 January 2018	Classification IAS 39	Classification IFRS 9	Closing balance IAS 39	Reclassi-fication	Remeasure-ment	Opening balance IFRS 9
Cash and balances with Central Bank	Loans & receivables	Amortised cost	189,045	-	-	189,045
Listed bonds and debt instruments	Held for trading	Mandatorily at FVTPL	24,716	-	-	24,716
Listed bonds and debt instruments	Designated as at FVTPL*	Mandatorily at FVTPL	373	-	-	373
Unlisted bonds and debt instruments	Designated as at FVTPL*	Mandatorily at FVTPL	2,001	-	-	2,001
Listed shares and equity instruments	Held for trading	Mandatorily at FVTPL	5,108	-	-	5,108
Listed shares and equity instruments	Designated as at FVTPL	Mandatorily at FVTPL	1,645	-	-	1,645
Unlisted shares and equity instruments	Designated as at FVTPL	Mandatorily at FVTPL	2,188	-	-	2,188
Unlisted shares and equity instruments	Available for sale	Fair value through OCI	1,236	-	-	1,236
Derivatives	Held for trading	Mandatorily at FVTPL	2,891	5	-	2,896
Derivatives	Held for hedging	Held for hedging**	5	(5)	-	-
Loans to credit institutions	Loans & receivables	Amortised cost	26,617	-	(39)	26,578
Loans to customers	Loans & receivables	Amortised cost	755,175	-	(2,706)	752,469
Other financial assets	Loans & receivables	Amortised cost	9,847	-	(3)	9,844
Total financial assets			1,020,847	-	(2,748)	1,018,099
Deposits from CB and credit institutions	Amortised cost	Amortised cost	11,189	-	-	11,189
Deposits from customers	Amortised cost	Amortised cost	567,029	-	-	567,029
Derivative instruments and short positions	Held for trading	Mandatorily at FVTPL	5,071	421	-	5,492
Derivative instruments and short positions	Held for hedging	Held for hedging**	421	(421)	-	-
Debt issued and other borrowed funds	Designated as at FVTPL	Designated as at FVTPL***	-	82,655	1,908	84,563
Debt issued and other borrowed funds	Amortised cost	Amortised cost	217,748	(82,655)	-	135,093
Subordinated loans	Amortised cost	Amortised cost	9,505	-	-	9,505
Other financial liabilities	Amortised cost	Amortised cost	10,467	-	-	10,467
Total financial liabilities			821,430	-	1,908	823,338

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3. Cont'd

*At the date of initial application of IFRS 9 the Group reclassified certain bonds and debt instruments from designated as at FVTPL to mandatorily at FVTPL. These bonds and debt instruments are managed and evaluated on a fair value basis and are therefore to be mandatorily measured at fair value through profit or loss. No bonds and debt instruments are classified as designated at fair value through profit or loss or at fair value through OCI.

**IFRS 9 includes new hedge accounting rules, which align hedge accounting more closely with risk management. IFRS 9 includes an accounting policy choice to defer the adoption of IFRS 9 hedge accounting and to continue with IAS 39 hedge accounting. The Group has decided to exercise this accounting policy choice. On 1 January 2018 the Group discontinued applying hedge accounting for certain euro denominated debt securities and interest rate swaps.

***At the date of initial application of IFRS 9 the Group changed the classification of certain debt securities to being designated as at fair value through profit or loss. The impact of this change on 1 January 2018 was ISK 1,908 million (see Note 37).

Allowance for credit losses

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The following table is a comparison of impairment allowances determined in accordance with IAS 39 and IAS 37 to the corresponding impairment allowance determined in accordance with IFRS 9 as at 1 January 2018.

	IAS 39				IFRS 9			
	Collectively assessed	Individually assessed	Total	Transition adjustments	Stage 1	Stage 2	Stage 3	Total
Loans at amortised cost*	1,729	8,662	10,391	2,745	2,741	1,244	9,151	13,136
Other assets at amortised cost	-	47	47	3	6	2	42	50
Off-balance sheet loan commitments and financial guarantees	-	64	64	610	467	101	106	674
Total allowance for credit losses	1,729	8,773	10,502	3,358	3,214	1,347	9,299	13,860

*Loans at amortised cost includes Loans to customers and Loans to credit institutions.

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4. Changes to IFRS standards issued but not effective at the reporting date

A number of new IFRS standards and amendments to standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Changes that are likely to affect the Group's future financial reporting are described below, no significant impact is expected.

IFRS 16 – Leases

The Group adopted a new standard IFRS 16 – Leases, as of 1 January 2019. The new standard sets out the principles for the recognition, measurement, presentation and disclosure of leases and supersedes current leasing standards and interpretations within IFRS, such as IAS 17 – Leases. The standard removes the current requirement for lessees to classify leases as finance leases or operating leases by introducing a single lessee accounting model that requires the recognition of right-of-use assets and lease liabilities on the balance sheet. Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset in the income statement.

The Group applied IFRS 16 initially on 1 January 2019, using the modified retrospective approach and measuring the carrying amounts of right-of-use assets equal to lease liabilities at adoption.

The Group has completed an assessment, as a lessee, of the potential impact on its consolidated financial statements based on its operating leases and the economic conditions as at 31 December 2018. The Group will recognise new assets and liabilities for its leases of branches and office buildings. According to the results of the assessment, the carrying amount of the lease liabilities will be ISK 4,494 million, the same as the right-of-use assets.

The standard will only have insignificant changes to the accounting for lessors.

IFRS 9 – Financial Instruments, Prepayment Features with Negative Compensation

The Group adopted amendment to IFRS 9 – Financial Instruments , as of 1 January 2019 relating to the Solely payments of principal and interest (SPPI) test. With the amendment the word „additional“ was deleted from the requirement of SPPI that a prepayment option will only be consistent with „Basic lending features“ if the prepayment amount represents the principal amount outstanding plus accrued interest and may include a reasonable additional compensation for early termination. Before the amendment, the compensation for early termination could not be received by the party excercising the option. Subsequent to the amendment, a compensation that reflects changes in the relevant benchmark interest rate will be consistent with the SPPI test, regardless of whether the compensation is positive or negative. The SPPI test is described further in Note 72.3. The amendment will not have a significant impact on the Group's consolidated financial statements.

5. Operating segments

Segment information is presented in accordance with the Group’s management and internal reporting structure.

The separation of Retail Banking into Personal Banking and Business Banking marks the final step towards implementing the Bank’s organisational changes initiated and introduced in the second quarter of 2017. At the end of the year the Bank has three main business segments: Personal Banking, Business Banking and Corporate & Investment Banking.

Operating segments pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium.

The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market.

The Group comprises the following operating segments:

Personal Banking
Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. Íslandsbanki’s customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank’s efficient branch network for comprehensive consultancy services.

Business Banking
Business Banking provides wide-ranging financial services to small- and medium-sized enterprises. Business Banking is organized around the branches where it can service its customers close to their own business. In addition, Business Banking operates Ergo, the asset based financing unit of the Bank.

5. Cont'd

Corporate & Investment Banking

Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors and affluent individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage and private banking services. The division is sector-focused, building and maintaining relationships with key customer segments within Iceland. Outside of Iceland, Íslandsbanki has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury and Proprietary trading

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for the relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business units sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres

Cost centres comprise the CEO’s office (Human Resources, Marketing & Communications, Strategy and Legal), Finance excluding Treasury and Proprietary Trading, Operations & IT, Risk Management and Compliance. Group Internal Audit is included in cost centres, however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank’s Board of Directors.

Subsidiaries, Eliminations and Adjustments

Subsidiaries include Borgun hf., Íslandssjóðir hf., Allianz Ísland hf. and other less significant subsidiaries (see Note 29).

Following is an overview showing the Group's performance with a breakdown by operating segments. Comparative amounts due to the organisational changes have not been restated.

Changes from prior periods include the additional line of income taxes, with breakdown for each segment according to the current tax rate and allocation of cost centres per segment within the Bank. Bank tax and contribution to the Icelandic Depositors’ and Investors’ Guarantee Fund are shown separately and allocated across segments. The allocation of Bank tax is based on the expected long-term ratio, as stated in the national budget. Furthermore, a line for depreciation and amortisation has been added.

5. Cont'd

The year 2018	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries eliminations & adjustments	The Group total
Net interest income	9,946	9,788	7,676	3,649	(218)	30,841	1,096	31,937
Net fee and commission income	4,564	1,477	3,321	(109)	12	9,265	2,962	12,227
Other operating income	1	41	353	1,070	282	1,747	(924)	823
Total operating income	14,511	11,306	11,350	4,610	76	41,853	3,134	44,987
Salaries and related expenses	(2,585)	(2,069)	(1,641)	(258)	(6,185)	(12,738)	(2,762)	(15,500)
Other operating expenses	(2,466)	(1,062)	(680)	(494)	(5,646)	(10,348)	(1,802)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(669)	(395)	(109)	-	-	(1,173)	-	(1,173)
Bank tax	(434)	(327)	(470)	(2,041)	(9)	(3,281)	-	(3,281)
Net impairment on financial assets	579	955	164	(37)	-	1,661	(77)	1,584
Cost allocation	(5,134)	(2,813)	(2,660)	423	10,184	-	-	-
Profit (loss) before tax	3,802	5,595	5,954	2,203	(1,580)	15,974	(1,507)	14,467
Income tax expense	(989)	(1,455)	(1,548)	(1,280)	411	(4,861)	127	(4,734)
Profit (loss) for the year from continuing operations	2,813	4,140	4,406	923	(1,169)	11,113	(1,380)	9,733
Net segment revenue from external customers	14,958	14,996	17,337	(5,733)	295	41,853	3,134	44,987
Net segment revenue from other segments	(447)	(3,690)	(5,987)	10,343	(219)	-	-	-
Fee and commission income	5,990	1,612	3,420	133	12	11,167	8,686	19,853
Depreciation and amortisation	(275)	(142)	(26)	(38)	(688)	(1,169)	(143)	(1,312)
At 31 December 2018								
Loans to customers	299,429	219,608	322,974	904	-	842,915	3,684	846,599
Other assets	1,332	3,151	316	252,085	8,056	264,940	18,864	283,804
Total segment assets	300,761	222,759	323,290	252,989	8,056	1,107,855	22,548	1,130,403
Deposits from customers	275,265	164,738	101,417	42,566	-	583,986	(5,027)	578,959
Other liabilities	1,453	2,811	3,199	345,375	2,317	355,155	19,976	375,131
Total segment liabilities	276,718	167,549	104,616	387,941	2,317	939,141	14,949	954,090
Allocated equity	24,582	37,304	57,200	48,982	646	168,714	7,599	176,313
Risk exposure amount	164,795	239,073	360,923	61,986	3,316	830,093	15,856	845,949

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

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Notes to the Consolidated Financial Statements

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Subsidiaries, eliminations & adjustments

The year 2018	Borgun hf.	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	1,021	28	19	15	13	1,096
Net fee and commission income	1,104	1,028	950	(31)	(89)	2,962
Other operating income	3	21	13	519	(1,480)	(924)
Total operating income	2,128	1,077	983	503	(1,556)	3,134
Salaries and related expenses	(2,072)	(529)	(157)	-	(4)	(2,762)
Other operating expenses	(1,323)	(200)	(432)	(3)	156	(1,802)
Net impairment on financial assets	(76)	-	-	-	(1)	(77)
Profit (loss) before tax	(1,343)	348	394	499	(1,405)	(1,507)
Income tax expense	274	(74)	(79)	(1)	7	127
Profit (loss) for the year from cont. operations	(1,069)	274	315	498	(1,398)	(1,380)
Net segment revenue from external customers	2,813	1,217	939	1,125	(2,960)	3,134
Net segment revenue from other segments	(685)	(140)	44	(622)	1,403	-
Fee and commission income	9,331	1,421	950	-	(3,016)	8,686
Depreciation and amortisation	(141)	-	(3)	-	1	(143)
At 31 December 2018						
Total assets	28,498	2,466	1,043	9,352	(18,811)	22,548
Total liabilities	22,154	196	231	1,860	(9,492)	14,949
Total equity	6,344	2,270	812	7,492	(9,319)	7,599

The year 2017	Retail Banking	Corporate & Investment Banking	Treasury	Proprietary Trading & Subsidiaries	Cost centres & eliminations	Total
Net interest income	19,948	5,890	3,583	828	(250)	29,999
Net fee and commission income	6,018	3,165	(152)	4,699	20	13,750
Other operating income	20	260	(526)	4,562	(3,876)	440
Total operating income	25,986	9,315	2,905	10,089	(4,106)	44,189
Salaries and related expenses	(4,692)	(1,842)	(172)	(2,845)	(5,682)	(15,233)
Other operating expenses	(3,653)	(446)	(245)	(2,337)	(5,054)	(11,735)
Deposit Guarantee Fund	(1,059)	(12)	(10)	(2)	-	(1,083)
Bank tax	-	-	(2,892)	-	-	(2,892)
Net loan impairment	361	1,077	-	22	96	1,556
Cost allocation	(3,653)	(3,545)	422	(49)	6,825	-
Profit (loss) before tax	13,290	4,547	8	4,878	(7,921)	14,802
Income tax expense	(3,456)	(1,182)	612	(1,157)	1,032	(4,151)
Profit (loss) for the year from cont. operations	9,834	3,365	620	3,721	(6,889)	10,651
Net segment revenue from external customers	23,360	16,132	(2,377)	10,923	(3,849)	44,189
Net segment revenue from other segments	2,626	(6,817)	5,282	(834)	(257)	-
Depreciation and amortisation	(271)	(15)	(3)	(202)	(467)	(958)
At 31 December 2017						
Loans to customers	477,173	271,875	-	6,123	4	755,175
Other assets	3,676	1,038	222,690	58,435	(5,192)	280,647
Total segment assets	480,849	272,913	222,690	64,558	(5,188)	1,035,822
Deposits from customers	486,486	15,803	66,357	861	(2,478)	567,029
Other liabilities	6,906	2,099	249,695	27,262	1,786	287,748
Total segment liabilities	493,392	17,902	316,052	28,123	(692)	854,777
Allocated equity	59,078	45,272	63,497	22,498	(9,300)	181,045
Risk exposure amount	399,614	310,989	16,977	50,346	(2,434)	775,492

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6. Classification of financial assets and financial liabilities

At 31 December 2018

	Notes	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Fair value through OCI	Amortised cost	Carrying amount
Cash and balances with Central Bank	23	-	-	-	-	135,056	135,056
Listed bonds and debt instruments		67,901	-	-	-	-	67,901
Unlisted bonds and debt instruments		1,514	-	-	-	-	1,514
Listed shares and equity instruments		8,386	-	-	-	-	8,386
Unlisted shares and equity instruments		2,846	-	-	1,842	-	4,688
Derivatives	24	3,923	627	-	-	-	4,550
Loans to credit institutions	25	-	-	-	-	41,577	41,577
Loans to customers	26	-	-	-	-	846,599	846,599
Other financial assets		-	-	-	-	7,511	7,511
Total financial assets		84,570	627	-	1,842	1,030,743	1,117,782
Deposits from CB and credit institutions	34	-	-	-	-	15,619	15,619
Deposits from customers	35	-	-	-	-	578,959	578,959
Derivative instruments and short positions	24	5,521	-	-	-	-	5,521
Debt issued and other borrowed funds	37	-	40,714	68,154	-	192,108	300,976
Subordinated loans	38	-	-	-	-	16,216	16,216
Other financial liabilities		-	-	-	-	27,186	27,186
Total financial liabilities		5,521	40,714	68,154	-	830,088	944,477

At 31 December 2017

	Held for trading	Held for hedging	Designated as at FVTPL	Loans & receivables	Available for sale	Liabilities at amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	189,045	-	-	189,045
Listed bonds and debt instruments	24,716	-	373	-	-	-	25,089
Unlisted bonds and debt instruments	-	-	2,001	-	-	-	2,001
Listed shares and equity instruments	5,108	-	1,645	-	-	-	6,753
Unlisted shares and equity instruments	-	-	2,188	-	1,236	-	3,424
Derivatives	2,891	5	-	-	-	-	2,896
Loans to credit institutions	-	-	-	26,617	-	-	26,617
Loans to customers	-	-	-	755,175	-	-	755,175
Other financial assets	-	-	-	9,847	-	-	9,847
Total financial assets	32,715	5	6,207	980,684	1,236	-	1,020,847
Deposits from CB and credit institutions	-	-	-	-	-	11,189	11,189
Deposits from customers	-	-	-	-	-	567,029	567,029
Derivative instruments and short positions	5,071	421	-	-	-	-	5,492
Debt issued and other borrowed funds	-	-	-	-	-	217,748	217,748
Subordinated loans	-	-	-	-	-	9,505	9,505
Other financial liabilities	-	-	-	-	-	10,467	10,467
Total financial liabilities	5,071	421	-	-	-	815,938	821,430

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7. Fair value information for financial instruments

Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell 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 Group 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.

The table below shows financial instruments carried at fair value at 31 December 2018 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Valuation techniques based on observable inputs other than the quoted prices included in Level 1, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Valuation techniques based on significant unobservable inputs, e.g. internal assumptions.

At 31 December 2018

	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	67,901	-	1,514	69,415
Shares and equity instruments	8,344	42	4,688	13,074
Derivative instruments	-	4,550	-	4,550
Total financial assets	76,245	4,592	6,202	87,039
Derivative instruments	-	5,521	-	5,521
Debt issued and other borrowed funds designated as at FVTPL	68,154	-	-	68,154
Total financial liabilities	68,154	5,521	-	73,675

At 31 December 2017

	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	25,132	130	1,828	27,090
Shares and equity instruments	6,714	90	3,373	10,177
Derivative instruments	-	2,896	-	2,896
Total financial assets	31,846	3,116	5,201	40,163
Short positions	270	-	-	270
Derivative instruments	-	5,222	-	5,222
Total financial liabilities	270	5,222	-	5,492

Changes of Level 3 assets measured at fair value:	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2018	1,828	3,373
Purchases	8	790
Net loss on financial instruments recognised in profit or loss	(249)	(135)
Net gain on financial instruments recognised in other comprehensive income	-	610
Transfers from level 1 or 2	-	50
Other	(73)	-
Fair value at 31 December 2018	1,514	4,688

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	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2017	1,872	2,072
Purchases	13	578
Sales	(10)	(2)
Net (loss) gain on financial instruments recognised in profit or loss	(48)	126
Net gain on financial instruments recognised in other comprehensive income	-	417
Transfers from Level 1 or 2	-	206
Other	1	(24)
Fair value at 31 December 2017	1,828	3,373

The responsibility for the valuation of fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

At the end of each reporting period the Group determines whether transfers have occured between levels in the hierarchy, by reassessing categorisation based on the lowest level input that is significant to the fair value measurement as a whole.

Level 1: Fair value established from quoted market prices.

Level 1 financial assets and financial liabilities contain actively traded bonds and equities that are listed either domestically or abroad.

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

Level 2 assets and liabilities contain domestic bonds, equities as well as derivatives. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates.

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

Level 3 assets contain primarily unlisted and illiquid equities and bonds. Unlisted equities and bonds are initially recorded at their transaction price but are revalued each quarter based on the models as described above. At 31 December 2018 the Group's Level 3 equities amounted to ISK 4,688 million. These include shares in five professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,663 million. The Group receives information from fund managers which use valuation models for the valuation of these equities. Full access to information of all components in these valuation models is unavailable to the Group and therefore no basis for assumptions for sensitivity analysis.

The Group holds Series C preferred shares in Visa Inc., amounting to ISK 1,842 million, which are subject to selling restrictions for a period of up to 10 years and under certain conditions may have to be recalled. The fair value of the preferred shares is closely linked to the market value of Visa Inc. at NYSE stock exchange, written down by 30% due to uncertainty of the final number of shares and marketability.

For other level 3 equities, changes in components for valuation will have minimal impact on the Group's income statement.

The Group's Level 3 bonds amounted to ISK 1,514 million. The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on projected risk and financing cost.

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8. Financial instruments not carried at fair value

Assets

The fair value of “Loans to customers” may differ from their net carrying amount because the interest rates they carry may not reflect the interest rates that similar new loans would carry. The fair value is estimated by subtracting from or adding to the net carrying amount of the loans the discounted interest rate difference calculated from the reporting date until the next interest reset or maturity, whichever comes first. Since the interest rate difference is estimated using internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is adequately approximated by the carrying amount as they are short-term in nature. They are thus classified as Level 2.

Liabilities

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. Most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. The fair value for longer term fixed rate deposits is calculated with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

Observed market value is used for the fair value of "Debt issued and other borrowed funds" where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin in the Group's issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions and liabilities to retailers for credit card provisions and they are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

The following tables show the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined in Note 7.

At 31 December 2018	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	135,056	-	135,056	135,056
Loans to credit institutions	-	41,577	-	41,577	41,577
Loans to customers	-	-	848,751	848,751	846,599
Other financial assets	-	7,511	-	7,511	7,511
Total financial assets	-	184,144	848,751	1,032,895	1,030,743
Deposits from Central Bank and credit institutions	-	15,633	-	15,633	15,619
Deposits from customers	-	579,232	-	579,232	578,959
Debt issued and other borrowed funds	151,767	84,476	-	236,243	232,822
Subordinated loans	16,167	-	-	16,167	16,216
Other financial liabilities	-	27,186	-	27,186	27,186
Total financial liabilities	167,934	706,527	-	874,461	870,802

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At 31 December 2017	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	189,045	-	189,045	189,045
Loans to credit institutions	-	26,617	-	26,617	26,617
Loans to customers	-	-	759,526	759,526	755,175
Other financial assets	-	9,847	-	9,847	9,847
Total financial assets	-	225,509	759,526	985,035	980,684
Deposits from Central Bank and credit institutions	-	11,192	-	11,192	11,189
Deposits from customers	-	567,235	-	567,235	567,029
Debt issued and other borrowed funds	119,819	104,482	-	224,301	217,748
Subordinated loans	9,457	-	-	9,457	9,505
Other financial liabilities	-	10,467	-	10,467	10,467
Total financial liabilities	129,276	693,376	-	822,652	815,938

9. Offsetting financial assets and financial liabilities

The tables below show reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

Financial assets	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2018	Financial assets before netting	Netting with financial liabilities	Net financial assets	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 financial assets recognised in the balance sheet
Reverse repurchase agreements	153	-	153	-	-	-	153	-	153
Derivatives	4,550	-	4,550	(1,655)	(1,383)	(698)	814	-	4,550
Total assets	4,703	-	4,703	(1,655)	(1,383)	(698)	967	-	4,703
At 31 December 2017									
Reverse repurchase agreements	618	-	618	(270)	-	-	348	-	618
Derivatives	2,896	-	2,896	(733)	(1,482)	(9)	672	-	2,896
Total assets	3,514	-	3,514	(1,003)	(1,482)	(9)	1,020	-	3,514

Financial liabilities	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2018	Financial liabilities before netting	Netting with financial assets	Net financial liabilities	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 financial liabilities recognised in the balance sheet
Derivative instruments and short positions	5,521	-	5,521	(1,655)	(85)	-	3,781	-	5,521
At 31 December 2017									
Derivative instruments and short positions	5,492	-	5,492	(733)	(492)	-	4,267	-	5,492

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Notes to the Consolidated Financial Statements

10. Quarterly statements (unaudited)

2018	Q4	Q3	Q2	Q1	Total
Net interest income	8,294	8,301	7,602	7,740	31,937
Net fee and commission income	3,478	2,939	3,032	2,778	12,227
Net financial (expense) income	(637)	(420)	378	(283)	(962)
Net foreign exchange gain (loss)	76	(8)	(57)	(10)	1
Other operating income	120	64	1,587	13	1,784
Salaries and related expenses	(4,047)	(3,501)	(4,026)	(3,926)	(15,500)
Other operating expenses	(3,418)	(2,962)	(2,846)	(2,924)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(299)	(295)	(287)	(292)	(1,173)
Bank tax	(740)	(944)	(812)	(785)	(3,281)
Net impairment on financial assets	(297)	(53)	1,846	88	1,584
Profit before tax	2,530	3,121	6,417	2,399	14,467
Income tax expense	(1,118)	(1,136)	(1,465)	(1,015)	(4,734)
Profit for the period from continuing operations	1,412	1,985	4,952	1,384	9,733
Profit from discontinued operations, net of income tax	(8)	126	81	713	912
Profit for the period	1,404	2,111	5,033	2,097	10,645

2017	Q4	Q3	Q2	Q1	Total
Net interest income	7,338	7,450	7,814	7,397	29,999
Net fee and commission income	3,632	3,305	3,543	3,270	13,750
Net financial income (expense)	260	(1,084)	97	12	(715)
Net foreign exchange gain	81	76	169	201	527
Other operating income	122	291	55	160	628
Salaries and related expenses	(4,297)	(3,168)	(4,109)	(3,659)	(15,233)
Other operating expenses	(3,358)	(2,879)	(2,739)	(2,759)	(11,735)
Contribution to the Depositors' and Investors' Guarantee Fund	(288)	(280)	(262)	(253)	(1,083)
Bank tax	(614)	(806)	(752)	(720)	(2,892)
Net loan impairment	969	147	200	240	1,556
Profit before tax	3,845	3,052	4,016	3,889	14,802
Income tax expense	(816)	(1,072)	(1,133)	(1,130)	(4,151)
Profit for the period from continuing operations	3,029	1,980	2,883	2,759	10,651
Profit from discontinued operations, net of income tax	83	93	2,114	285	2,575
Profit for the period	3,112	2,073	4,997	3,044	13,226

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11. Net interest income

	2018	2017
Cash and balances with Central Bank	7,279	10,541
Loans at amortised cost	52,462	45,162
Financial assets mandatorily at fair value through profit or loss	1,825	-
Financial assets designated as at fair value through profit or loss	-	50
Financial assets held for trading	-	879
Other assets	109	135
Total interest income	61,675	56,767
Deposits from credit institutions and Central Bank	(409)	(170)
Deposits from customers	(16,539)	(17,461)
Debt issued and other borrowed funds at fair value through profit or loss	(963)	-
Debt issued and other borrowed funds at amortised cost	(9,035)	(8,107)
Subordinated loans	(198)	(14)
Other financial liabilities	(2,565)	(995)
Other interest expense	(29)	(21)
Total interest expense	(29,738)	(26,768)
Net interest income	31,937	29,999
Interest margin (as the ratio of net interest income to the average carrying amount of total assets)	2.9%	2.9%

12. Net fee and commission income

	2018	2017
Asset management	2,116	1,964
Investment banking and brokerage	2,303	2,280
Payment processing	12,065	13,094
Loans and guarantees	1,467	1,427
Other fee and commission income	1,902	2,090
Total fee and commission income	19,853	20,855
Brokerage	(300)	(128)
Clearing and settlement	(7,302)	(6,956)
Other commission expenses	(24)	(21)
Total commission expenses	(7,626)	(7,105)
Net fee and commission income	12,227	13,750

Fee and commission income by segment is disclosed in Note 5.

13. Net financial expense

	2018	2017
Net loss on financial assets and liabilities held for trading	-	(1,239)
Net gain on financial assets designated as at fair value through profit or loss	-	480
Net loss on financial assets and liabilities mandatorily at FVTPL	(720)	-
Net loss on financial liabilities designated as at FVTPL	(240)	-
Net (loss) gain on fair value hedges	(2)	44
Net financial expense	(962)	(715)

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	2018	2017
Shares and related derivatives	(576)	-
Dividend income	38	-
Bonds and related derivatives	(197)	-
Other derivatives	15	-
Net loss on financial assets and liabilities mandatorily at FVTPL	(720)	-

	2018	2017
Debt issued and other borrowed funds designated as at FVTPL	(240)	-
Net loss on financial liabilities designated as at FVTPL	(240)	-

	2018	2017
Clean fair value gain (loss) on interest rate swaps designated as hedging instruments	486	(57)
Fair value (loss) gain on bonds issued by the Group attributable to interest rate risk	(488)	101
Net (loss) gain on fair value hedges	(2)	44

14. Net foreign exchange gain

	2018	2017
Cash and balances with Central Bank	(193)	(140)
Financial assets held for trading	-	2,503
Financial assets designated as at fair value through profit or loss	-	(93)
Financial assets mandatorily at fair value through profit or loss	2,281	-
Loans at amortised cost	17,120	2,062
Other assets	305	244
Net foreign exchange gain for assets	19,513	4,576
Deposits	(7,938)	859
Debt issued and other borrowed funds designated as at FVTPL	(3,868)	-
Debt issued and other borrowed funds at amortised cost	(6,567)	(4,613)
Subordinated loans	(884)	(241)
Other liabilities	(255)	(54)
Net foreign exchange loss for liabilities	(19,512)	(4,049)
Net foreign exchange gain	1	527

15. Other operating income

	2018	2017
Share of profit of associates, net of income tax	29	142
Net gain (loss) from sale of subsidiaries and associates*	1,526	(60)
Legal cost and fees	83	100
Rental income	37	38
Gain from sale of buildings	1	290
Other net operating income	108	118
Other operating income	1,784	628

*In the second quarter of 2018 the Group sold a subsidiary, which owned land in Reykjavík.

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16. Personnel and salaries

	2018	2017
Salaries	11,923	12,212
Contributions to pension funds	1,767	1,734
Social security charges and financial activities tax*	1,723	1,758
Other	95	106
Capitalisation of internal staff costs in software development	(8)	(577)
Salaries and related expenses	15,500	15,233

*Financial activities tax calculated on salaries is 5.5% (2017: 5.5%).

The Group's total number of employees is as follows:

	2018		2017	
	The Bank	The Group	The Bank	The Group
Average number of employees	873	1,076	915	1,098
Positions at the end of the year	834	1,075	861	1,042

Total amount of compensation to the Board of Directors, the CEO and Executive Board are specified as follows:

	2018	2017
Friðrik Sophusson, Chairman of the Board	11.3	10.6
Helga Valfells, Vice-Chairman of the Board	9.0	8.2
Anna Þórðardóttir, member of the Board	7.8	7.4
Auður Finnbogadóttir, member of the Board	7.5	7.0
Árni Stefánsson, member of the Board	7.5	7.0
Hallgrímur Snorrason, member of the Board	7.5	7.0
Heiðrún Jónsdóttir, member of the Board	7.7	7.0
Alternate board members	0.4	0.8
Total salaries	58.7	55.0

	2018		2017	
	Total salaries	Contri-butions to pension funds	Total salaries	Contri-butions to pension funds
Birna Einarsdóttir, CEO	63.5	14.0	58.0	11.6
Managing Directors	250.3	36.0	331.5	50.1
Total	313.8	50.0	389.5	61.7

The organisational changes in 2017 resulted in changes in the executive board, reducing the number of managing directors from eight to six. All expenses related to these changes were recognised in the income statement in 2017.

Benefits are non-monetary benefits such as the use of cars owned by the Group.

As of 1 January 2017, the Bank did not have a remuneration policy in place as stated in the Bank's compensation policy. In 2018 the Bank paid performance-based salaries which were earned in 2014. Included in total salaries are paid performance-based salaries for 2014. For the Bank’s CEO those amounted to ISK 3.9 million (2017: ISK 9.7 million) and for the managing directors the payments amounted to ISK 12.5 million (2017: ISK 44.2 million). According to the Financial Supervisory Authority rules on variable remuneration, the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. If the employee gives a notice of termination, the employee shall no longer be entitled to the deferred payment. Unpaid performance, at year-end, based on salaries for 2015-2016 will be paid on the appropriate due dates in 2019 and 2020.

Contribution to pension funds for the Board of Directors amounted to ISK 7.2 million in 2018 (2017: ISK 6.3 million).

There were no share based payments in the years 2018 and 2017.

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17. Other operating expenses

	2018	2017
Professional services	5,309	5,069
Real estate and fixtures	3,440	3,148
Depreciation and amortisation	1,312	1,022
Other administrative expenses	2,089	2,496
Other operating expenses	12,150	11,735

18. Auditors' fees

	2018	2017
Audit of the annual accounts	117	104
Review of interim accounts	24	22
Other services	15	11
Auditors' fees	156	137

19. Net impairment on financial assets

	2018	2017
Allowance for expected credit losses, on-balance sheet items	529	-
Allowance for expected credit losses, off-balance sheet items	38	-
Specific impairment	-	(2,478)
Collective impairment	-	317
Changes of provision due to court rulings	1,017	(737)
Impairment reversal due to revised estimated future cash flows	-	4,454
Net impairment on financial assets	1,584	1,556

20. Income tax expense

Income tax is recognised based on applicable tax rates and tax laws. The income tax rate for legal entities in 2018 is 20% (2017: 20%). Special financial activities tax is calculated as 6% of taxable profits exceeding ISK 1 billion in accordance with the Act on Financial Activities Tax no. 165/2011. The effective income tax rate in the Group's income statement for the year is 32.7% (2017: 28.0%).

	2018	2017
Current tax expense excluding discontinued operations	3,205	3,771
Special financial activities tax	860	832
Difference in prior year's imposed and calculated income tax	196	(53)
Changes in temporary differences due to deferred tax assets and deferred tax liabilities	473	(399)
Income tax recognised in the income statement	4,734	4,151

	2018	2017
Income tax due to the implementation of IFRS 9	(884)	-
Income tax due to equity activities	(884)	-

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	2018		2017	
Profit before tax	14,467		14,802	
20% income tax calculated on the profit of the year	2,893	20.0%	2,960	20.0%
Special financial activities tax	860	5.9%	832	5.6%
Expenses (income) not subject to tax	217	1.5%	(11)	(0.1%)
Non-deductible expenses	657	4.5%	584	3.9%
Other differences	107	0.8%	(214)	(1.4%)
Effective income tax expense	4,734	32.7%	4,151	28.0%

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

21. Profit from discontinued operations

	2018	2017
Net profit from sales of foreclosed mortgages	58	305
Net share of profit from disposal groups held for sale	854	360
Net profit from sale of subsidiaries	-	1,910
Profit from discontinued operations, net of income tax	912	2,575

22. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2018	2017	2018	2017
Profit attributable to shareholders of the Bank	10,124	11,002	11,036	13,577
Weighted average number of outstanding shares	10,000	10,000	10,000	10,000
Basic earnings per share	1.01	1.10	1.10	1.36

The Group's basic and diluted earnings per share are equal as the Group has not issued any options, warrants, convertables, or other potential sources of dilution (2017: none).

23. Cash and balances with Central Bank

	31.12.2018	31.12.2017
Cash on hand	3,095	1,976
Balances with Central Bank	114,849	169,503
Balances with Central Bank assets subject to special restrictions*	3,049	4,593
Included in cash and cash equivalents	120,993	176,072
Mandatory reserve deposits with Central Bank**	14,063	12,973
Cash and balances with Central Bank	135,056	189,045

*Balances as defined in Act no. 37/2016 on the treatment of króna-denominated assets subject to special restrictions and rules no. 490/2016 on special reserve requirements for new foreign currency inflows.

**The Monetary Policy Committee of the Central Bank of Iceland has decided to change the arrangements for credit institutions' minimum reserve requirements so as to divide the reserve requirement into two parts: a fixed 1% reserve requirement bearing no interest, and a 1% reserve requirement of the type that has been in place, currently bearing 4% interest. The objective of these changes is to reduce the cost to the Central Bank in relation to foreign cash reserves. The new rules on minimum reserve requirements no. 585/2018 took effect on 21 June 2018.

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24. Derivative instruments and short positions

At 31 December 2018	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	1,037	102,429	3,422	134,010
Cross-currency interest rate swaps	1,821	69,691	1,184	28,309
Equity forwards	419	4,596	78	1,195
Foreign exchange forwards	359	9,242	196	3,869
Foreign exchange swaps	875	35,726	440	13,373
Bond forwards	39	3,511	201	19,993
Derivatives	4,550	225,195	5,521	200,749
Short positions in listed bonds	-	-	-	-
Total	4,550	225,195	5,521	200,749

At 31 December 2017				
Interest rate swaps	724	77,754	2,687	120,284
Cross-currency interest rate swaps	613	33,023	1,924	29,512
Equity forwards	217	1,669	99	1,846
Equity options	19	152	-	-
Foreign exchange forwards	211	7,263	117	5,992
Foreign exchange swaps	1,095	19,100	325	24,813
Bond forwards	17	2,444	70	7,430
Derivatives	2,896	141,405	5,222	189,877
Short positions in listed bonds	-	-	270	-
Total	2,896	141,405	5,492	189,877

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

Short positions are in Icelandic Government bonds and bonds issued by institutions with government guarantees. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain EUR denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate EUR denominated bonds (see Note 37) arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. The total fair value of the interest rate swaps at year-end 2018 was positive and amounted to ISK 627 million. Their total notional amount at year-end 2018 was ISK 39,696 million. At the beginning of 2018 the Group derecognised certain EUR denominated interest rate swaps as hedging instruments and classified them as mandatorily at fair value through profit and loss due to changes in classification of certain EUR denominated bonds. The notional amount of those interest rate swaps was ISK 62,525 million at year-end 2017.

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25. Loans to credit institutions

	31.12.2018	31.12.2017
Money market loans	16,314	10,658
Bank accounts	25,259	15,959
Other loans	4	-
Loans to credit institutions	41,577	26,617

26. Loans to customers

At 31 December 2018	Gross carrying amount			ECL allowance			Net carrying amount
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3	
Individuals	308,870	5,901	6,860	(1,130)	(256)	(855)	319,390
Commerce and services	118,563	4,981	3,358	(643)	(179)	(1,838)	124,242
Construction	25,958	3,301	298	(196)	(247)	(19)	29,095
Energy	6,145	740	-	(20)	(7)	-	6,858
Financial services	1,708	-	-	(4)	-	-	1,704
Industrial and transportation	74,338	2,625	3,800	(398)	(53)	(488)	79,824
Investment companies	18,709	5,128	398	(217)	(103)	(116)	23,799
Public sector and non-profit organisations	12,054	22	30	(18)	-	(1)	12,087
Real estate	139,073	2,588	2,087	(528)	(154)	(181)	142,885
Seafood	103,014	3,616	479	(123)	(80)	(191)	106,715
Loans to customers	808,432	28,902	17,310	(3,277)	(1,079)	(3,689)	846,599

At 31 December 2017	Gross amount	Specific impairment allowance	Loans less impairment allowance
Individuals	301,502	(2,152)	299,350
Commerce and services	115,128	(2,984)	112,144
Construction	25,816	(1,019)	24,797
Energy	7,109	-	7,109
Financial services	26	-	26
Industrial and transportation	71,258	(1,297)	69,961
Investment companies	20,138	(412)	19,726
Public sector and non-profit organisations	11,871	-	11,871
Real estate	127,323	(256)	127,067
Seafood	85,395	(542)	84,853
Loans to customers before collective impairment allowance	765,566	(8,662)	756,904
Collective impairment allowance			(1,729)
Loans to customers			755,175

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27. Expected credit loss

Loans to customers

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2018	2,701	1,244	9,151	13,096
Transfer to Stage 1	2,652	(1,733)	(919)	-
Transfer to Stage 2	(1,053)	2,317	(1,264)	-
Transfer to Stage 3	(99)	(1,167)	1,266	-
Net remeasurement of loss allowance	(2,073)	126	(429)	(2,376)
New financial assets originated or purchased	1,474	478	711	2,663
Derecognitions and maturities	(323)	(185)	(618)	(1,126)
Write-offs	(2)	(1)	(5,254)	(5,257)
Recoveries of amounts previously written off	-	-	416	416
Foreign exchange	-	-	87	87
Unwinding of interests	-	-	542	542
At 31 December 2018	3,277	1,079	3,689	8,045

Total expected credit loss

	Stage 1	Stage 2	Stage 3	Total
Cash and balances with Central Bank	48	-	-	48
Loans to credit institutions	62	-	-	62
Loans to customers	3,277	1,079	3,689	8,045
Other financial assets	5	3	83	91
Off-balance sheet loan commitments and financial guarantees	410	142	84	636
At 31 December 2018	3,802	1,224	3,856	8,882

Changes in the provision for impairment losses for loans to customers according to IAS 39:	Specific impairment allowance	Collective impairment allowance	Total
At 1 January 2017	11,472	2,049	13,521
Amounts written-off	(5,905)	(3)	(5,908)
Recoveries of amounts previously written-off	617	-	617
Charged to the income statement	2,478	(317)	2,161
At 31 December 2017	8,662	1,729	10,391

28. Investments in associates

	2018	2017
Investments in associates at the beginning of the year	704	450
Additions during the year	86	36
Sales of shares in associates	(39)	-
Transfer from associates to subsidiaries	(80)	-
Share of results	29	142
Dividends paid	(18)	(25)
Impairment	-	(60)
Other	-	161
Investments in associates	682	704

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28. Cont'd

The Group's interest in its associates are as follows:		31.12.2018	31.12.2017
Auðkenni hf., an information security company, Borgartún 31, 105 Reykjavík	Iceland	23.8%	23.8%
JCC ehf., a cash centre service company, Borgartún 19, 105 Reykjavík	Iceland	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company, Katrínartún 2, 105 Reykjavík	Iceland	30.8%	30.8%
B-Payment Szolgáltató Zrt., a payment processing company, H-1132 Budapest	Hungary	-	45.0%
FAST GP ehf., a holding company, Katrínartún 2, 105 Reykjavík	Iceland	-	35.0%
Summa Rekstrarfélag hf., an investment fund company, Tjarnargata 4, 101 Reykjavík	Iceland	-	25.0%

Summarised financial information in respect of the Group's associates is set out below:	2018	2017
Revenue	5,487	4,770
Profit	171	109
Assets	5,291	5,564
Liabilities	(2,932)	(3,280)
Net assets	2,359	2,284
Group's share of net assets of associates	682	704

29. Investments in subsidiaries

		31.12.2018	31.12.2017
Borgun hf., a payment acquirer and issuing processor, Ármúli 30, 108 Reykjavík	Iceland	63.5%	63.5%
B-Payment Group Szolgáltató Zrt., a payment processing company, H-1132 Budapest	Hungary	100%	-
Íslandssjóðir hf., an investment fund management company, Hagasmári 3, 201 Kópavogur	Iceland	100%	100%
Hringur-eignarhaldsfélag ehf., a holding company, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%

During the third quarter the Group gained control over its associate B-Payment Szolgáltato Zrt. and its three subsidiaries, thereby making them subsidiaries of the Group.

In addition Íslandsbanki has control over 13 other non-significant subsidiaries.

Borgun hf. is the only significant subsidiary of Íslandsbanki that has a material non-controlling interest, 2018: 36.5% (2017: 36.5%).

The following table summarises key information relevant to Borgun hf.:

	2018	2017
Loans at amortised cost	7,425	8,652
Other assets	21,073	23,001
Liabilities	22,154	24,829
Net assets	6,344	6,824
Carrying amount of non-controlling interests	2,318	2,491
Revenue	10,383	15,110
(Loss) profit	(1,069)	350
Other comprehensive income for the year, net of tax	610	415
Total comprehensive income	(459)	765
Profit (loss) allocated to non-controlling interests	(167)	279
Cash flows from operating activities	(4,500)	(4,156)
Cash flows from investing activities	371	18
Cash flows from financing activities	19	(4,461)
Net decrease in cash and cash equivalents	(4,110)	(8,599)

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Notes to the Consolidated Financial Statements

30. Property and equipment

At 31 December 2018		Fixtures,	
Historical cost	Land and buildings	equipment & vehicles	Total
Balance at the beginning of the year	5,722	4,683	10,405
Additions during the year	15	829	844
Disposals and write-offs during the year	(1,683)	(1,528)	(3,211)
Total	4,054	3,984	8,038
Accumulated depreciation			
Balance at the beginning of the year	(1,330)	(1,947)	(3,277)
Depreciation during the year	(72)	(496)	(568)
Disposals and write-offs during the year	-	1,078	1,078
Total	(1,402)	(1,365)	(2,767)
Carrying amount	2,652	2,619	5,271
Depreciation rates	0-2%	8-33%	
Official real estate value of buildings and land			3,747
Insurance value of buildings			4,889
Insurance value of fixtures, equipment and vehicles			3,500

At 31 December 2017		Fixtures,	
Historical cost	Land and buildings	equipment & vehicles	Total
Balance at the beginning of the year	5,295	4,860	10,155
Additions during the year	107	1,279	1,386
Disposals and write-offs during the year	320	(1,456)	(1,136)
Total	5,722	4,683	10,405
Accumulated depreciation			
Balance at the beginning of the year	(1,256)	(2,688)	(3,944)
Depreciation during the year	(74)	(602)	(676)
Disposals and write-offs during the year	-	1,343	1,343
Total	(1,330)	(1,947)	(3,277)
Carrying amount	4,392	2,736	7,128
Depreciation rates	0-2%	8-33%	
Official real estate value of buildings and land			4,647
Insurance value of buildings			6,158
Insurance value of fixtures, equipment and vehicles			3,892

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31. Intangible assets

At 31 December 2018

Historical cost	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,381	3,090	-	4,471
Additions during the year and internal development	479	555	248	1,282
Disposals during the year	(221)	(1)	-	(222)
Total	1,639	3,644	248	5,531
Accumulated amortisation				
Balance at the beginning of the year	(39)	(201)	-	(240)
Amortisation during the year	(345)	(106)	-	(451)
Disposals during the year	162	-	-	162
Total	(222)	(307)	-	(529)
Carrying amount	1,417	3,337	248	5,002
Amortisation rates	10-25%	10-25%	-	

At 31 December 2017

Historical cost	Purchased software	Developed software	Total
Balance at the beginning of the year	1,598	1,774	3,372
Additions during the year and internal development	487	1,316	1,803
Disposals during the year	(704)	-	(704)
Total	1,381	3,090	4,471
Accumulated amortisation			
Balance at the beginning of the year	(499)	(201)	(700)
Amortisation during the year	(180)	-	(180)
Disposals during the year	640	-	640
Total	(39)	(201)	(240)
Carrying amount	1,342	2,889	4,231
Amortisation rates	25%	10-25%	

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Notes to the Consolidated Financial Statements

32. Other assets

	31.12.2018	31.12.2017
Receivables	5,793	6,736
Unsettled securities transactions	1,033	2,620
Accruals	289	205
Prepaid expenses	395	215
Deferred tax assets	215	4
Other assets	222	213
Other assets	7,947	9,993

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

	31.12.2018	31.12.2017
Repossessed collateral	1,012	1,224
Assets of disposal groups classified as held for sale	218	1,542
Total	1,230	2,766

Land and property	995	1,194
Industrial equipment and vehicles	17	30
Repossessed collateral	1,012	1,224

At year-end 2018 the Group classified the assets and liabilities of the following subsidiaries as assets and liabilities of disposal groups held for sale: Fastengi ehf. (100%), ÍSB fasteignir ehf. (100%) and LT lóðir ehf. (100%).

Assets and liabilities of disposal groups classified as held for sale:

	31.12.2018	31.12.2017
Equity instruments	-	775
Receivables	-	484
Property and land	193	252
Other assets	25	31
Total assets	218	1,542

Payables	1	1
Tax liabilities	5	79
Total liabilities	6	80

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Notes to the Consolidated Financial Statements

34. Deposits from Central Bank and credit institutions

	31.12.2018	31.12.2017
Repurchase agreements with Central Bank	92	92
Deposits from credit institutions	15,527	11,097
Deposits from Central Bank and credit institutions	15,619	11,189

35. Deposits from customers

	31.12.2018	31.12.2017
Demand deposits*	499,170	479,590
Time deposits	79,789	87,439
Deposits from customers	578,959	567,029

*Demand deposits include deposits with maturity of up to 3 months.

Deposits from customers specified by owners:

	31.12.2018		31.12.2017	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	9,331	2%	6,071	1%
Municipalities	5,574	1%	7,054	1%
Companies	278,209	48%	290,405	51%
Individuals	285,845	49%	263,499	47%
Deposits from customers	578,959	100%	567,029	100%

36. Pledged assets

	31.12.2018	31.12.2017
Financial assets pledged as collateral against liabilities	190,471	149,663
Financial assets pledged as collateral in foreign banks	1,105	908
Financial assets pledged as collateral in repurchase agreements	153	618
Pledged assets against liabilities	191,729	151,189

The Group has pledged assets against the issuance of covered bonds under Icelandic law, which are pledged on a pool of consumer mortgage loans. The underlying cover pool must withstand a weekly stress test.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

The comparative amount in the line item "Financial assets pledged as collateral against liabilities" at 31.12.2017 has been increased by ISK 4,800 million for comparison with 31.12.2018 to take into consideration assets pledged as collateral to the Central Bank of Iceland to secure settlement in the Icelandic cash clearing systems.

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37. Debt issued and other borrowed funds

	Issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
Covered bond in ISK*	2014-2017	2019	At maturity	Fixed rates	9,866	10,120
Covered bond in ISK	2015-2018	2023	At maturity	Fixed rates	10,890	7,469
Covered bond in ISK - CPI-linked	2012-2014	2019	At maturity	Fixed rates	8,937	8,666
Covered bond in ISK - CPI-linked	2014-2015	2020	At maturity	Fixed rates	4,248	4,117
Covered bond in ISK - CPI-linked	2015-2017	2022	At maturity	Fixed rates	18,009	17,467
Covered bond in ISK - CPI-linked	2012-2018	2024	At maturity	Fixed rates	35,009	21,963
Covered bond in ISK - CPI-linked	2015-2018	2026	At maturity	Fixed rates	26,992	24,049
Covered bond in ISK - CPI-linked	2017-2018	2030	At maturity	Fixed rates	24,862	15,089
Covered bonds					138,813	108,940
Senior unsecured bond in EUR**	2015-2016	2018	At maturity	Fixed rates	-	19,004
Senior unsecured bond in NOK	2015	2018	At maturity	Floating rates	-	6,391
Senior unsecured bond in SEK	2015	2019	At maturity	Floating rates	7,844	7,660
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	400	375
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	2,665	2,500
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	1,333	1,253
Senior unsecured bond in EUR**	2016	2020	At maturity	Fixed rates	68,154	63,651
Senior unsecured bond in SEK	2018	2019	At maturity	Floating rates	1,302	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	1,303	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	1,311	-
Senior unsecured bond in SEK	2018	2022	At maturity	Floating rates	12,995	-
Senior unsecured bond in SEK	2018	2020	At maturity	Floating rates	3,259	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	13,750	-
Senior unsecured bond in EUR***	2018	2024	At maturity	Fixed rates	40,714	-
Bonds issued					155,030	100,834
Bills issued					6,729	7,538
Other debt securities					404	436
Other borrowed funds					7,133	7,974
Debt issued and other borrowed funds					300,976	217,748

*Íslandsbanki repurchased own covered bonds during the year amounting to ISK 184 million.

**At the date of initial application of IFRS 9 the Group changed the classification of certain debt securities to being designated as at fair value through profit or loss. The impact of this change on 1.1.2018 amounted to ISK 1,908 million. At 31 December 2018 the total carrying amount of the bond issuance amounted to ISK 68,154 million and included in the amount are fair value changes amounting to ISK 401 million. The carrying amount of the debt securities designated as at fair value through profit or loss at 31 December 2018 was ISK 374 million higher than the contractual amount due at maturity.

***The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments (see Note 24). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. At 31 December 2018 the total carrying amount of the bond issuances amounted to ISK 40,714 million and included in the amount are fair value changes amounting to ISK 488 million.

The covered bond amounts do not contain the bonds reserved for securities lending.

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38. Subordinated loans

	Issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	At maturity	Floating, STIBOR + 2.0%	9,724	9,505
Subordinated loans in SEK*	2018	2028	At maturity	Floating, STIBOR + 2.5%	6,492	-
Subordinated loans					16,216	9,505

*The Group issued an SEK 500 million Tier 2 bond in the third quarter of 2018.

39. Changes in liabilities arising from financing activities

					Non-cash changes			
	31.12.2017	Reclas & remeasure	1.1.2018	Cash flows	Interest expense	Foreign exchange movement	Fair value changes	31.12.2018
Covered bonds NIL	17,589	-	17,589	2,055	1,112	-	-	20,756
Covered bonds CPI	91,351	-	91,351	20,134	6,572	-	-	118,057
Senior unsecured bonds FX	37,182	(19,003)	18,179	23,275	531	4,177	-	46,162
Senior unsecured bonds FX at fair value ...	-	84,563	84,563	(20,083)	963	3,868	(1,157)	68,154
Senior unsecured bonds used for hedging	63,652	(63,652)	-	37,406	430	2,390	488	40,714
Short-term borrowings	7,974	-	7,974	(1,231)	390	-	-	7,133
Subordinated loans	9,505	-	9,505	5,629	198	884	-	16,216
Total	227,253	1,908	229,161	67,185	10,196	11,319	(669)	317,192

			Non-cash changes				
	1.1.2017	Cash flows	Interest expense	Foreign exchange movement	Fair value changes	Other	31.12.2017
Covered bonds NIL	15,491	1,031	1,067	-	-	-	17,589
Covered bonds CPI	48,733	27,170	3,365	-	-	12,083	91,351
Senior unsecured bonds FX	64,133	(30,854)	2,361	1,542	-	-	37,182
Other loans	17,207	(2,690)	-	-	-	(14,517)	-
Senior unsecured bonds used for hedging	61,125	(1,108)	665	3,071	(101)	-	63,652
Short-term borrowings	5,779	1,835	360	-	-	-	7,974
Subordinated loans	-	9,250	14	241	-	-	9,505
Total	212,468	4,634	7,832	4,854	(101)	(2,434)	227,253

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40. Tax assets and tax liabilities

	31.12.2018		31.12.2017	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	6,472	-	7,699
Deferred tax	215	678	4	88
Tax in the balance sheet	215	7,150	4	7,787

Changes in the deferred tax assets and the tax liabilities during the year were as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2017	4	487
Calculated income tax for 2017	(47)	3,545
Income tax payable in 2018	47	(3,800)
Prior year's income tax adjustment	-	(144)
Deferred tax assets and tax liabilities 31.12.2017	4	88
Calculated income tax for 2018	211	3,888
Income tax payable in 2019	-	(3,214)
Income tax due to equity activities	-	(94)
Prior year's income tax adjustment	-	10
Deferred tax assets and tax liabilities 31.12.2018	215	678

Movements in temporary differences during the year were as follows:

2018	Net balance at 1 January	Recognised in profit or (loss)	Recognised in equity	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(79)	(170)	-	(249)	-	(249)
Intangible assets	(395)	(132)	-	(527)	-	(527)
Assets and liabilities denominated in foreign currency	(186)	(78)	-	(264)	-	(264)
Deferred foreign exchange difference	(202)	(11)	-	(213)	-	(213)
Derivatives	465	(271)	-	194	194	-
Debt issued and other borrowed funds	314	(79)	94	329	329	-
Other items	(1)	(1)	-	(2)	-	(2)
Tax loss carry forwards	-	269	-	269	269	-
	(84)	(473)	94	(463)	792	(1,255)
Set-off of deferred tax assets together with liabilities of the same taxable entities					(577)	577
Tax assets (liabilities)	(84)	(473)	94	(463)	215	(678)

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40. Cont'd

2017	Net balance at 1 January	Recognised in profit or (loss)	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(147)	68	(79)	-	(79)
Intangible assets	(175)	(220)	(395)	-	(395)
Assets and liabilities denominated in foreign currency	(183)	(3)	(186)	-	(186)
Deferred foreign exchange difference	23	(225)	(202)	4	(206)
Derivatives	-	465	465	465	-
Debt issued and other borrowed funds	-	314	314	314	-
Other items	-	(1)	(1)	-	(1)
Tax loss carry forwards	(1)	1	-	-	-
	(483)	399	(84)	783	(867)
Set-off of deferred tax assets together with liabilities of the same taxable entities				(779)	779
Tax assets (liabilities)	(483)	399	(84)	4	(88)

41. Other liabilities

	31.12.2018	31.12.2017
Accruals	3,906	4,049
Liabilities to retailers for credit cards	20,722	23,878
Provision for effects of court rulings	-	1,811
Off-balance sheet loan commitments and financial guarantees	636	64
Withholding tax	1,733	1,596
Unsettled securities transactions	612	1,384
Deferred income	193	199
Sundry liabilities	1,841	2,966
Other liabilities	29,643	35,947

Reconciliation of off-balance sheet loan commitments and financial guarantees:

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2018	467	101	106	674
Transfer to Stage 1	595	(545)	(50)	-
Transfer to Stage 2	(58)	67	(9)	-
Transfer to Stage 3	(6)	(69)	75	-
Net remeasurement of loss allowance	(828)	481	(132)	(479)
New loan commitments and financial guarantees	521	130	132	783
Derecognitions and maturities	(281)	(23)	(38)	(342)
At 31 December 2018	410	142	84	636

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42. Custody assets

	31.12.2018	31.12.2017
Custody assets - not managed by the Group	2,167,946	2,101,434

43. Leases

Future non-cancellable minimum operating lease payments, where the Group is lessee:

	31.12.2018	31.12.2017
Due within 1 year	470	438
Due in 1-5 years	1,831	1,752
Due in more than 5 years	2,842	3,430
Operating lease commitments	5,143	5,620

The Group has lease agreements in place for its headquarters and some of the branches. A typical lease agreement is CPI-linked with a duration of 5-10 years and has an extension clause.

In 2018 the Group paid ISK 492 million for the operating leases (2017: ISK 437 million).

Net investment in finance lease receivables, where the Group is lessor:

	31.12.2018	31.12.2017
Due within 1 year	18,524	14,398
Due in 1-5 years	30,195	29,916
Due in more than 5 years	3,011	3,301
Total gross investment in the lease	51,730	47,615
Due within 1 year	16,069	12,031
Due in 1-5 years	26,730	26,219
Due in more than 5 years	2,317	2,515
Total present value of lease payments	45,116	40,765
Unearned financial income	6,614	6,850
Accumulated loan-loss provision	193	187
Variable lease payments recognised as income during the year	3,166	2,999

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44. Related party

Íslandsbanki is wholly owned by the Icelandic Government, directly and through ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments (ISFI). As a result, the Icelandic Government and the Icelandic State Financial Investments are defined as related parties. The Group has applied the partial exemption for government-related entities, as described in IAS 24, and does not disclose those transactions in the related party note.

The Board of Directors and key management personnel of the Bank, ISFI, ISB Holding ehf. and subsidiaries of the Bank, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner, the Bank and other Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third party counterparties.

Cash and balances with the Central Bank are disclosed under Note 23 and Deposits from the Central Bank are disclosed under Note 34.

All loans to employees are provided on general business terms of the Group and the balances do not reflect collaterals held by the Group.

At 31 December 2018	Assets	Liabilities	Net balance	Commitments & overdrafts
Shareholders with control over the Group	-	105	(105)	-
Board of Directors, key management personnel and other related parties	220	493	(273)	82
Associated companies	198	469	(271)	210
Balances with related parties	418	1,067	(649)	292

1 January - 31 December 2018	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	2	-	-
Board of Directors and key management personnel	16	10	2	-
Associated companies	15	10	2	1,937
Transactions with related parties	31	22	4	1,937

At 31 December 2017	Assets	Liabilities	Net balance	Commitments & overdrafts
Shareholders with control over the Group	-	103	(103)	1
Board of Directors and key management personnel	287	415	(128)	59
Associated companies and other related parties	330	743	(413)	232
Balances with related parties	617	1,261	(644)	292

1 January - 31 December 2017	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	3	-	-
Board of Directors and key management personnel	16	13	-	-
Associated companies and other related parties	24	25	2	1,801
Transactions with related parties	40	41	2	1,801

At year-end 2018 ISK 2 million were recognised as Stage 1 expected credit loss against balances outstanding with related parties (2017: none). No share option programmes were operated during the reporting period 1 January - 31 December. For related party renumeration see Note 16.

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45. Contingencies

Provisions

Variable rate loan contracts

The Consumer Agency concluded in 2014 that previous mortgage loan interest reset terms offered by the Group and its predecessors in the years between 2004-2011 did not fulfil the requirements of the law on consumer loans. The Supreme Court found in favour of the Consumer Agency in October 2017. Close to 1,600 customers were affected. The Group had early on recognised a provision of ISK 800 million against the loss due to this ruling. This provision proved to be sufficient and repayments to customers have been completed.

Contingent liabilities

Borgun hf.

Borgun hf., a subsidiary of Íslandsbanki, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun in late 2014. Landsbankinn claims that Borgun's management did not release all available information that might have affected the value of Borgun during the sales process, namely the worth of its stake in Visa Europe which was sold to Visa International shortly after the Borgun sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. The plaintiff does not quantify the claim, but his estimate of the loss of profit is approximately ISK 1,930 million (by selling the shares in Borgun). Seeing that the conclusion of the case is uncertain and the financial effect cannot be estimated, the Group has not recognised a provision in relation to this matter. The court has appointed professionals to assess the claim but it is uncertain when the assessment will be completed. Therefore it is uncertain when a ruling is to be expected.

Kortaþjónustan hf.

Kortaþjónustan hf., a payment acquirer, filed a suit against Íslandsbanki hf., Arion banki hf., Landsbankinn hf., Borgun hf., and Valitor hf. in June 2013. The plaintiff asked for damages in the amount of ISK 1,191 million, plus interest, mainly due to alleged infringements of competition law. Later claims amount to ISK 923 million plus interest, collectively. The case has been dismissed two times by the courts on technical grounds. The plaintiff filed the case for the third time last November. The Group has not recognised a provision in relation to this matter.

Contingent assets

Settlement of the 2011 Byr acquisition

The Group acquired Byr hf. ("Byr"), a former savings bank, in 2011, 88.4% from Byr Sparisjóður and 11.6% from the Icelandic Ministry of Finance and Economic Affairs ("Ministry"). In June 2013 the Group filed a priority claim with the winding-up board of Byr, sparisjóður. The winding-up board rejected the Group’s claim and referred the dispute to the District Court of Reykjavík. Subsequently the Group made a formal claim with the Ministry that has also been submitted to the District Court of Reykjavík. The District Court of Reykjavík confirmed the Composition Agreement of Byr Savings Bank on 8 January 2016. At the same time the name of Byr, sparisjóður was changed to Old Byr. In February 2019 Íslandsbanki and Old Byr reached an agreement on the settlement of the dispute, that entails a payment to the Group in the amount of ISK 975 million, payable by mid-April 2019 and that upon the payment the parties agree to dismiss the case. Simultaneously, Old Byr will make a distribution to the Group, in accordance with the bonds issued to creditors as part of the composition of Old Byr. We anticipate that an equitable settlement will be reached with the Ministry on the dismissal of that case. The Group has not recognised any revenues relating to these claims, see Note 46.

46. Events after the reporting period

As detailed in Note 45, Íslandsbanki and Old Byr agreed in February 2019 to settle their legal dispute. It is anticipated that an equitable agreement will be reached with the Ministry. Further to this Old Byr will make a distribution in accordance with notes issued to its creditors as part of the composition of Old Byr. As a result of this, it is anticipated that the Group will recognise approximately ISK 1.5 billion in revenue, in the first quarter of 2019.

47. Risk management

Risk governance

The Group is exposed to various risk factors and managing these risks is an integral part of its operations. The Bank emphasises sound governance principles. The risk management and internal control framework of the Group is based on a three lines of defence model, as referred to in the European Banking Authority Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Group's internal rules.

The first line of defence consists of the Bank's business and support units; the second line of defence comprises the Bank's internal control units, risk management and compliance; and the third line of defence is Internal Audit which gives the Board an independent assessment of the quality of corporate governance, risk management and internal controls.

The Group's management body has a dual structure. The Board of Directors of the bank has a supervising role in setting and monitoring the execution of set policies, the sound control of accounting and financial management and ensuring that group internal audit, compliance and risk management are effective. The Chief Executive Officer (CEO), the Chief Risk Officer (CRO), other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at the Group lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through risk management policies and the Risk Appetite Statement. To assist the Board in fulfilling its oversight responsibilities, the Board has appointed three board subcommittees.

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Group's operations are consistent with applicable legislation and the Group's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer (CRO), the Compliance Officer as well as other members of the Executive Board. The CEO also engages the members of the senior management committees.

The CRO heads the risk management function and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at the Group and for verifying that the Bank has the right resources and an appropriate organisation to manage its risks efficiently.

The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the Group and cannot be removed without the Board's prior approval.

The CRO is independent from the business units, is a member of the Executive Board and reports directly to the CEO. The CRO provides an independent view on the Group's exposure to risk. The CRO has the right but not the responsibility to veto certain risk-taking decisions of the senior management committees if an internal control unit considers the proposal inconsistent with the Bank's risk appetite, policies or procedures.

Risk management is mandated to identify, understand, measure and monitor the risks that the Group is exposed to. It provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by the management and business or support units as to whether they are consistent with the risk appetite and risk polices set by the Board.

Where necessary, risk management makes recommendations to senior management and the Board to improve or clarify risk policies, procedures and limits.

Risk Management provides a holistic view on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

Business and support units are, however, responsible for maintaining their independent view on the risks inherent in their operations and reporting to senior management any foreseeable breaches from limits, policies or strategic direction.

Risk management provides the senior management and the Board with all relevant risk related information to enable it to define the Bank's risk appetite.

The General Counsel is appointed by and reports directly to the CEO. The General Counsel provides legal advice to the Bank's senior management, including the Board of Directors, and manages the Bank's legal department which provides comprehensive legal advice to the Bank's profit centres and support units.

The Chief Audit Executive (CAE) is appointed by the Board, reports directly to Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Group, including internal audit tasks which have been outsourced.

47. Cont'd

The Compliance Officer heads the compliance function and is responsible for defining the daily tasks of the department and assessing the adequacy of its professional skills. The Compliance Officer is responsible for monitoring the compliance risk management framework for the Bank and maintaining oversight for compliance risk throughout the Bank.

The Bank's Compliance Officer is selected and engaged by the CEO, subject to Board confirmation. The Compliance Officer cannot be removed without the Board's prior approval. The FME and Chief Audit Executive shall be notified of the dismissal or departure of the Compliance Officer.

The Compliance Officer reports directly to the Board on the overall compliance risk profile of the Bank.

Each employee is responsible for understanding the risk related to their day-to-day work, for knowing and understanding the respective internal and external rules and procedures, for using the alert procedures in the event of possible fraudulent activities and for conducting business in accordance with the Bank's code of conduct.

The Bank's senior management committee structure is twofold. Firstly the two executive committees, the Executive Board and the All Risk Committee, that are responsible for the implementation of the Board approved business strategy, risk appetite and policies. Secondly the four business committees, the Asset and Liability Committee (ALCO), the Senior Credit Committee (SCC), the Investment Committee (IC) and the Operational and Security Committee (OSC), which are responsible for the approval of business or operational proposals subject to internal rules and guidelines issued by the executive committees and the Board.

The members of the senior management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter issued by the CEO.

48. Credit risk

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 financial contract with the Group.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. industrial sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes 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 loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as financial guarantees, loan commitments and derivatives.

The Group has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Group's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Group measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

49. Maximum credit exposure

The Group'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. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions that have been made because of these items. The maximum credit exposure for a derivative contract is calculated by adding potential future credit exposure to the positive market value of the contract.

The industry breakdown shows the 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 Group's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

Credit risk exposure

49. Cont'd

Maximum credit exposure at 31 December 2018

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	135,056	-	-	-	-	-	-	-	-	-	135,056
Bonds and debt instruments	-	53,341	-	-	447	12,925	1,724	68	724	186	-	69,415
Derivatives	-	-	121	2	2,322	4,687	451	1,090	-	61	205	8,939
Loans to credit institutions	-	-	-	-	-	41,577	-	-	-	-	-	41,577
Loans to customers:	319,390	-	124,242	29,095	6,858	1,704	79,824	23,799	12,087	142,885	106,715	846,599
Overdrafts	11,769	-	11,699	3,304	31	1,509	4,483	780	754	4,501	9,751	48,581
Credit cards	15,779	-	1,516	251	4	21	433	33	112	59	34	18,242
Mortgages	249,296	-	-	-	-	-	-	-	-	-	-	249,296
Capital leases	6,504	-	27,552	2,270	5	-	7,166	116	48	1,197	258	45,116
Other loans	36,042	-	83,475	23,270	6,818	174	67,742	22,870	11,173	137,128	96,672	485,364
Other financial assets	409	-	451	5	1	6,532	23	34	3	18	35	7,511
Off-balance sheet items:	33,928	-	24,673	18,703	6,091	8,160	12,413	3,817	4,517	20,850	12,805	145,957
Financial guarantees	1,494	-	5,863	4,563	12	1,172	2,416	160	5	1,828	508	18,021
Undrawn loan commitments	-	-	4,986	11,662	5,996	-	4,899	1,100	-	14,629	5,782	49,054
Undrawn overdrafts	10,187	-	9,908	1,830	63	6,863	4,124	2,433	3,884	4,167	6,374	49,833
Credit card commitments	22,247	-	3,916	648	20	125	974	124	628	226	141	29,049
Total maximum credit exposure	353,727	188,397	149,487	47,805	15,719	75,585	94,435	28,808	17,331	164,000	119,760	1,255,054

Amounts are in ISK million

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Maximum credit exposure at 31 December 2017

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	189,045	-	-	-	-	-	-	-	-	-	189,045
Bonds and debt instruments	-	14,716	-	-	-	9,644	1,613	95	1,022	-	-	27,090
Derivatives	2	-	212	-	1,562	2,381	296	1,465	1	206	196	6,321
Loans to credit institutions	-	-	-	-	-	26,617	-	-	-	-	-	26,617
Loans to customers:	299,350	-	112,144	24,797	7,109	26	69,961	19,726	11,871	127,067	84,853	756,904
Overdrafts	11,352	-	11,874	3,376	11	5	4,686	1,607	352	4,990	7,397	45,650
Credit cards	16,397	-	1,510	234	4	21	406	37	107	51	33	18,800
Mortgages	225,765	-	-	-	-	-	-	-	-	-	-	225,765
Capital leases	7,528	-	22,077	2,258	6	-	7,316	206	70	1,085	219	40,765
Other loans	38,308	-	76,683	18,929	7,088	-	57,553	17,876	11,342	120,941	77,204	425,924
Other financial assets	414	8	243	4	1	8,935	26	27	97	90	2	9,847
Off-balance sheet items:	38,017	1	30,269	14,909	9,646	4,640	17,050	3,774	4,875	20,404	10,304	153,889
Financial guarantees	1,607	-	5,936	4,466	13	1,169	2,389	59	4	1,006	543	17,192
Undrawn loan commitments	-	-	10,263	7,587	9,402	-	9,514	3,041	-	16,266	2,175	58,248
Undrawn overdrafts	9,977	-	9,707	2,164	201	3,351	4,044	531	4,129	2,886	7,436	44,426
Credit card commitments	26,433	1	4,363	692	30	120	1,103	143	742	246	150	34,023
Total maximum credit exposure	337,783	203,770	142,868	39,710	18,318	52,243	88,946	25,087	17,866	147,767	95,355	1,169,713

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50. 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 Group takes a charge over assets such as real estate, 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 Group 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 Group'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 the gross carrying amount of loans and nominal off-balance sheet items, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their gross carrying amount, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. The maximum credit risk exposure is measured on net carrying value basis, and therefore collateral allocation can in some instances be higher.

For capital leases the Group remains the owner of the leased object. In total ISK 35,622 million of the collateral are leased objects.

The following tables show the maximum exposure to credit risk by class of financial asset and collateral held against those exposures.

An overview of collateral held by the Group against credit exposure is shown below for exposures in Stages 1 and 2 (non credit-impaired) and exposures in Stage 3 (credit-impaired):

At 31 December 2018 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral
Derivatives	8,939	-	-	2,232	-	-	2,232
Loans and commitments to customers:	978,396	563,362	89,350	6,149	49,883	69,902	778,646
Individuals	347,490	266,508	6	359	13,485	155	280,513
Commerce and services	146,286	56,407	733	189	27,574	23,915	108,818
Construction	47,495	28,694	-	379	1,880	3,761	34,714
Energy	12,949	3,737	-	366	-	5	4,108
Financial services	9,864	-	-	309	-	-	309
Industrial and transportation	89,289	39,523	9	82	6,437	15,980	62,031
Investment companies	27,392	9,588	26	2,891	83	11,361	23,949
Public sector and non-profit organisations	16,551	974	-	7	37	2	1,020
Real estate	161,864	144,530	-	1,549	231	1,113	147,423
Seafood	119,216	13,401	88,576	18	156	13,610	115,761
Total	987,335	563,362	89,350	8,381	49,883	69,902	780,878

Collateral held against credit-impaired exposures	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral
Loans and commitments to customers:	14,160	9,003	2,282	106	328	487	12,206
Individuals	5,828	5,256	17	7	83	3	5,366
Commerce and services	2,629	1,023	139	-	78	247	1,487
Construction	303	232	-	-	21	14	267
Industrial and transportation	2,948	317	2,077	99	109	170	2,772
Investment companies	224	180	-	-	-	-	180
Public sector and non-profit organisations	53	37	-	-	-	-	37
Real estate	1,871	1,829	-	-	1	-	1,830
Seafood	304	129	49	-	36	53	267
Total	14,160	9,003	2,282	106	328	487	12,206

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50. Cont'd

The table below was prepared in accordance with IAS 39 and is therefore not fully comparable to the table above.

At 31 December 2017	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	2,351	-	-	2,351
Loans and commitments to customers:	488,494	79,699	4,601	46,888	54,093	673,775
Individuals	251,052	22	501	13,127	172	264,874
Commerce and services	49,961	857	219	25,189	17,315	93,541
Construction	20,916	-	363	1,868	4,043	27,190
Energy	3,436	-	367	-	92	3,895
Financial services	-	-	166	-	-	166
Industrial and transportation	22,386	2,876	147	6,081	14,994	46,484
Investment companies	6,579	-	2,381	104	9,164	18,228
Public sector and non-profit organisations	881	-	10	53	5	949
Real estate	126,604	-	418	221	873	128,116
Seafood	6,679	75,944	29	245	7,435	90,332
Total	488,494	79,699	6,952	46,888	54,093	676,126

51. Credit quality of financial assets

The following table provides the gross carrying amount of loans and credit risk exposure on loan commitments and financial guarantees. Amounts are broken down by risk class and the method by which their respective credit loss allowances (ECL) are calculated, i.e. Stage 1, 2 and 3 as described in Note 72.3.

The Group 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 Group uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Group 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.

Risk classes 1-4 represent low risk, risk classes 5-6 moderate risk, risk classes 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers that are in default. Unrated are loans originating from subsidiaries of Íslandsbanki that do not have rating models, in addition to loans that are yet to be rated.

Further information on the risk classes, including the mapping from risk classes to the probability of default, can be found in Section 4.2.2 of the unaudited Pillar 3 report.

The same customer can have loans and off-balance sheet commitments in Stages 1 and 2 simultaneously. However, if a customer has an exposure in Stage 3 then all other loans and commitments are classified as Stage 3 as well.

As explained in Note 72.3, the Group has a new harmonised definition of default. The new definition is broader than each individual definition, in particular the previous definition of Risk class 10.

At 31 December 2018

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	213,012	104	-	213,116
Risk class 5-6	367,843	1,055	-	368,898
Risk class 7-8	184,807	15,339	-	200,146
Risk class 9	38,633	12,363	-	50,996
Risk class 10	-	-	17,215	17,215
Unrated	4,137	41	95	4,273
	808,432	28,902	17,310	854,644
Expected credit loss	(3,277)	(1,079)	(3,689)	(8,045)
Net carrying amount	805,155	27,823	13,621	846,599

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Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	68,712	30	-	68,742
Risk class 5-6	55,112	194	-	55,306
Risk class 7-8	16,913	1,899	-	18,812
Risk class 9	1,517	1,460	-	2,977
Risk class 10	-	-	623	623
Unrated	130	3	-	133
	142,384	3,586	623	146,593
Expected credit loss	(410)	(142)	(84)	(636)
Net carrying amount	141,974	3,444	539	145,957

At 31 December 2018	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	74,325	135,721	101,859	33,354	6,955	3,499	(2,395)	353,318
Commerce and services	33,700	84,690	23,538	5,455	3,718	585	(2,771)	148,915
Construction	3,387	21,930	21,711	1,024	336	53	(643)	47,798
Energy	11,472	544	965	-	-	-	(32)	12,949
Financial services	9,450	419	8	-	-	4	(17)	9,864
Industrial and transportation	34,253	41,922	8,331	4,930	3,705	69	(973)	92,237
Investment companies	5,709	6,976	10,751	4,241	414	-	(475)	27,616
Public sector and non-profit organisations	13,150	3,119	240	-	52	66	(23)	16,604
Real estate	41,768	73,484	44,312	2,909	2,172	36	(946)	163,735
Seafood	54,644	55,399	7,243	2,060	486	94	(406)	119,520
Total	281,858	424,204	218,958	53,973	17,838	4,406	(8,681)	992,556

The table below was prepared in accordance with IAS 39 and shows loans to customers that were neither past due nor impaired at year-end 2017. It is not comparable to the table above which shows all loans and commitments to customers.

At 31 December 2017	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers:							
Individuals	54,270	113,333	87,600	29,999	950	3,425	289,577
Commerce and services	21,236	64,388	18,353	2,686	108	1,434	108,205
Construction	591	9,206	12,299	888	325	-	23,309
Energy	3,193	3,062	854	-	-	-	7,109
Financial services	17	4	5	-	-	-	26
Industrial and transportation	24,940	22,181	15,420	3,430	2,816	19	68,806
Investment companies	1,214	6,109	11,470	534	9	-	19,336
Public sector and non-profit organisations	7,813	3,636	410	6	-	1	11,866
Real estate	35,534	55,614	29,396	2,455	321	33	123,353
Seafood	40,854	36,896	4,351	242	1	92	82,436
Total	189,662	314,429	180,158	40,240	4,530	5,004	734,023

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52. Forbearance and write-offs

When restructuring or modification measures are believed to be more appropriate than collection procedures, the Group offers several debt relief measures and restructuring frameworks for customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants.

From 1 January 2018, when a loan has been renegotiated or modified but not derecognised the Group also reassesses, after a certain trial period, whether the loan is still considered to have a significant increase in credit risk. The Group also considers whether forborne assets classified as Stage 3 should be recognised and transferred to Stage 2.

Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for a loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:
- All of the customer's facilities have to be considered performing; and
- The customer does not have any contract that is more than 30 days past due; and
- The probation period of two years has passed from the date the forborne contract was considered performing; and
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period.

The following table provides a summary of the Group's forborne assets.

At 31 December 2018

	Stage 1	Stage 2	Stage 3	Total
Individuals	1,741	2,020	1,238	4,999
Companies	14,377	2,016	4,588	20,981
Gross carrying amount	16,118	4,036	5,826	25,980

	Stage 1	Stage 2	Stage 3	Total
Individuals	(13)	(92)	(198)	(303)
Companies	(139)	(49)	(1,160)	(1,348)
Expected credit loss	(152)	(141)	(1,358)	(1,651)

Gross carrying amount written off during the year and still subject to enforcement activity:	Gross carrying amount
Individuals	1,514
Companies	3,756
Total	5,270

53. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

	31.12.2018	31.12.2017
Property and land	1,072	881
Industrial equipment and vehicles	41	81

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations. The Group's employees are not permitted to purchase foreclosed assets.

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54. Large exposures disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group'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 regulation no. 233/2017. The Group has internal criteria that define connections between clients. These criteria reflect the Group's interpretation of Article (1)(a) of the Act on Financial Undertakings no. 161/2002, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects. After mitigating effects, the Group currently has four large exposures, an increase of two since the last reporting date. No large exposure is above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects.

At 31 December 2018

Groups of connected clients:	Before	After
Group 1	73%	-
Group 2	12%	12%
Group 3	12%	11%
Group 4	11%	11%
Group 5	13%	11%

At 31 December 2017

Groups of connected clients:	Before	After
Group 1	102%	-
Group 2	11%	11%
Group 3	10%	10%

55. Liquidity risk

The Group 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.

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the Financial Supervisory Authority's guidelines no. 2/2010 on best practices in liquidity management and liquidity coverage ratio rules no. 266/2017.

The following tables show the LCR and NSFR for the group at year-end 2018 and 2017.

Net Stable Funding Ratio	31.12.2018	31.12.2017
For all currencies	114%	117%
Foreign currencies	149%	122%

Liquidity Coverage Ratio	31.12.2018	31.12.2017
For all currencies	172%	142%
Foreign currencies	544%	155%

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At 31 December 2018	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	169,217	169,217	42,608	42,608
Liquid assets level 2	2,754	775	2,754	775
Total liquid assets	171,971	169,992	45,362	43,383
Deposits	455,883	127,018	67,513	25,191
Debt issued	875	875	875	875
Other outflows	72,598	32,095	15,277	5,849
Total outflows	529,356	159,988	83,665	31,915
Short term deposits with other banks**	39,718	39,718	39,716	39,716
Other inflows	42,739	21,443	9,702	7,950
Restrictions on inflows	-	-	-	(23,730)
Total inflows	82,457	61,161	49,418	23,936
Liquidity coverage ratio		172%		544%

At 31 December 2017	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1	179,299	179,299	12,444	12,444
Liquid assets level 2	2,092	672	2,027	672
Total liquid assets	181,391	179,971	14,471	13,116
Deposits	429,365	129,957	65,502	29,500
Debt issued	575	575	56	56
Other outflows	88,979	32,192	10,928	3,534
Total outflows	518,919	162,724	76,486	33,090
Short term deposits with other banks	25,356	23,766	25,271	23,766
Other inflows	27,545	12,079	1,365	861
Total inflows	52,901	35,845	26,636	24,627
Liquidity coverage ratio		142%		155%

*Level 1 liquid assets include cash and balances with the Central Bank, domestic bonds eligible as collateral against borrowing at the CB and foreign government bonds in accordance with rules no. 266/2017 on liquidity ratio.

**Short-tem deposits with other banks with maturity less than 30 days.

The following tables show the contractual payments of principal and interest for the Group'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.

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Maturity analysis 31 December 2018

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Deposits from CB and credit institutions	15,619	4,594	3,229	4,992	3,249	-	-	16,064
Deposits from customers	578,959	420,242	81,178	37,952	26,976	38,070	-	604,418
Debt issued and other borrowed funds	300,976	404	24,214	21,178	154,315	141,098	-	341,209
Subordinated loans	16,216	-	90	307	2,242	20,417	-	23,056
Other financial liabilities	27,186	24,431	1,729	1,026	-	-	-	27,186
Total	938,956	449,671	110,440	65,455	186,782	199,585	-	1,011,933

Off-balance sheet liabilities show the amount of contractual obligations that the Group 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 Group'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 Group 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	18,021	-	-	-	-	-	18,021
Undrawn loan commitments	49,054	-	-	-	-	-	49,054
Undrawn overdrafts	49,833	-	-	-	-	-	49,833
Credit card commitments	29,049	-	-	-	-	-	29,049
Total	145,957	-	-	-	-	-	145,957
Total non-derivative financial liabilities and off-balance sheet liabilities	595,628	110,440	65,455	186,782	199,585	-	1,157,890

The table below shows the contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative and a positive carrying amount at the reporting date. 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.

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	-	20,124	23,147	49,380	1,771	-	94,422
Outflow	-	(20,638)	(24,189)	(51,654)	(1,943)	-	(98,424)
Total	-	(514)	(1,042)	(2,274)	(172)	-	(4,002)
Net settled derivatives	-	(280)	-	-	-	-	(280)
Total	-	(794)	(1,042)	(2,274)	(172)	-	(4,282)

Maturity classification of assets is based on contractual maturity. 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.

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Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	135,056	47,746	87,310	-	-	-	-	135,056
Bonds and debt instruments	69,415	-	18,946	24,189	14,409	11,604	267	69,415
Shares and equity instruments	13,074	-	-	-	-	-	13,074	13,074
Loans to credit institutions	41,577	24,152	17,425	-	-	-	-	41,577
Loans to customers	846,599	2,054	90,269	74,716	282,624	396,936	-	846,599
Other financial assets	7,511	1,888	475	71	9	-	5,068	7,511
Total	1,113,232	75,840	214,425	98,976	297,042	408,540	18,409	1,113,232

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	-	57,050	22,267	77,126	327	-	156,770
Outflow	-	(56,077)	(21,929)	(74,072)	(343)	-	(152,421)
Total	-	973	338	3,054	(16)	-	4,349
Net settled derivatives	-	869	-	-	-	-	869
Total	-	1,842	338	3,054	(16)	-	5,218

The tables below show the comparative amounts for financial assets and financial liabilities at year-end 2017.

Maturity analysis 31 December 2017

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	270	270	-	-	-	-	-	270
Deposits from CB and credit institutions	11,189	6,104	3,078	-	2,246	-	-	11,428
Deposits from customers	567,029	388,943	92,487	51,156	25,109	29,080	-	586,775
Debt issued and other borrowed funds	217,748	436	3,222	36,568	132,831	79,152	-	252,209
Subordinated loans	9,505	-	36	138	1,257	12,356	-	13,787
Other financial liabilities	10,467	6,181	3,273	1,012	-	-	-	10,466
Total	816,208	401,934	102,096	88,874	161,443	120,588	-	874,935

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	17,192	-	-	-	-	-	17,192
Undrawn loan commitments	58,248	-	-	-	-	-	58,248
Undrawn overdrafts	44,426	-	-	-	-	-	44,426
Credit card commitments	34,023	-	-	-	-	-	34,023
Total	153,889	-	-	-	-	-	153,889
Total non-derivative financial liabilities and off-balance sheet liabilities	555,823	102,096	88,874	161,443	120,588	-	1,028,824

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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	-	23,143	48,265	43,880	5,115	-	120,403
Outflow	-	(23,558)	(48,108)	(47,170)	(5,631)	-	(124,467)
Total	-	(415)	157	(3,290)	(516)	-	(4,064)
Net settled derivatives	-	(170)	-	-	-	-	(170)
Total	-	(585)	157	(3,290)	(516)	-	(4,234)

Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	189,045	31,396	153,098	-	-	4,551	-	189,045
Bonds and debt instruments	27,090	998	8,896	2,590	7,298	7,308	-	27,090
Shares and equity instruments	10,177	-	-	-	-	-	10,177	10,177
Loans to credit institutions	26,617	15,050	11,567	-	-	-	-	26,617
Loans to customers	755,175	4,172	77,809	84,286	220,524	370,113	-	756,904
Other financial assets	9,847	3,860	524	10	32	6	5,415	9,847
Total	1,017,951	55,476	251,894	86,886	227,854	381,978	15,592	1,019,680

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	-	25,982	52,964	30,231	813	-	109,990
Outflow	-	(24,827)	(51,416)	(28,728)	(880)	-	(105,851)
Total	-	1,155	1,548	1,503	(67)	-	4,139
Net settled derivatives	-	233	-	-	-	-	233
Total	-	1,388	1,548	1,503	(67)	-	4,372

As a part of managing liquidity risk, the Group 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 Group's liquid assets.

Composition and amount of liquid assets and deposits with other banks	31.12.2018	31.12.2017
Cash and balances with Central Bank	117,573	183,834
Domestic bonds eligible as collateral against borrowing at Central Bank	10,532	3,654
Foreign government bonds	41,588	11,872
Loans to credit institutions	39,718	23,768
Total	209,411	223,128

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56. Deposits by LCR category

The Group's deposits are categorised by counterparty according to the Liquidity Coverage Ratio (LCR) standard. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classified as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme. There is a difference between a few categories when comparing 2018 and 2017. A few lines have been combined in the 2018 table in order to be in line with the EBA LCR report.

	Deposits maturing within 30 days					
At 31 December 2018	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	216,428	12%	80,804	5%	78,476	375,708
Operational relationships	2,572	25%	-	5%	-	2,572
Corporations	63,887	40%	341	20%	22,809	87,037
Sovereigns, Central Bank and public sector entities	7,613	40%	246	20%	591	8,450
Pension funds	30,686	100%	-	-	26,987	57,673
Domestic financial entities	27,467	100%	-	-	24,622	52,089
Foreign financial entities	3,242	100%	-	-	7,807	11,049
Total	351,895		81,391		161,292	594,578

	Deposits maturing within 30 days					
At 31 December 2017	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	118,964	10%	63,715	5%	68,808	251,487
SMEs	55,958	10%	15,024	5%	6,847	77,829
Operational relationships	1,694	25%	-	5%	-	1,694
Corporations	64,114	40%	321	20%	27,327	91,762
Sovereigns, Central Bank and public sector entities	7,083	40%	234	20%	1,513	8,830
Financial institutions in composition	2,947	100%	-	-	-	2,947
Pension funds	31,271	100%	-	-	28,466	59,737
Domestic financial entities	30,849	100%	-	-	26,979	57,828
Foreign financial entities	4,868	100%	-	-	4,353	9,221
Other foreign entities	8,718	100%	2,214	25%	5,951	16,883
Total	326,466		81,508		170,244	578,218

57. Market risk

The Group 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 within the Group can broadly be split into two categories, trading book and banking book. The trading book includes market risk exposures related, directly or indirectly, to the Group's short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. 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. The banking book includes market risk exposures related to securities held for long-term investment purposes, unlisted securities or holdings in subsidiaries or affiliates. A large part of the banking book market risk is due to mismatches in the composition of assets and liabilities, for example with respect to currencies, interest rates, CPI-indexation or other factors that can affect the Group's earnings or earnings volatility. These mismatches are reported to management and are subject to internal and regulatory limits.

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58. Interest rate risk

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

Sensitivity measures like Basis Point Value (BPV) are used 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.

59. Interest rate risk in the trading book

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing Financing Fund (HFF) which are guaranteed by the Icelandic Government, domestic municipality bonds and covered bonds issued by other Icelandic banks. Bonds and bills in the Group's liquidity portfolio are also categorised in the trading book. In the table below the total market value (MV) of long and short positions may not be the same as reported in Note 6 since netting between short and long positions is not applied here. Derivatives and securities used for hedging are excluded from the table.

	31.12.2018			31.12.2017		
Trading bonds and debt instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	1,872	6.13	(1.15)	1,750	7.17	(1.25)
Non-indexed	43,550	0.32	(1.40)	14,148	0.51	(0.73)
Total	45,422	0.56	(2.55)	15,898	1.24	(1.98)

	31.12.2018			31.12.2017		
Trading bonds and debt instruments, short positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	-	-	-	-	-	-
Non-indexed	198	5.00	0.09	-	-	-
Total	198	5.00	0.09	-	-	-
Net position of trading bonds and debt instruments	45,224	0.54	(2.46)	15,898	1.24	(1.98)

60. Sensitivity analysis for interest rate risk in the trading book

The following table shows the interest rate sensitivity of the Group's trading book from a parallel 100 basis points change in all yield curves.

Sensitivity analysis for trading bonds and debt instruments		31.12.2018		31.12.2017	
		Profit (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	115	(115)	125	(125)
ISK, non-indexed	100	24	(24)	50	(50)
EUR	100	56	(56)	4	(4)
USD	100	29	(29)	14	(14)
Other total	100	-	-	6	(6)
Total		224	(224)	199	(199)

61. Interest rate risk in the banking book

Interest rate risk in the banking book arises from the Group'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 Group's assets and liabilities are of different maturities and are priced relative to different interest rates.

The impact on the Group's interest rate risk in the banking book due to the Supreme Court ruling on 12 October 2017 regarding interest rate reset terms on consumer mortgage contracts was not considered at year-end 2017 but is now taken into account. Part of the borrowers owing mortgage loans where the Group will not be able to reset interest rates have been asked to disclose their preferences with regards to refinancing and updating of the loan contracts. The number of remaining contracts is approximately 2,700 with a carrying amount of ISK 36 billion. In order to categorise those contracts in appropriate time buckets the Bank uses an internal model to estimate their expected time to maturity.

The following table shows the interest sensitivity of the Group's banking book from a parallel 100 basis points change in all yield curves, with all other variables held constant, categorised by the date of next interest rate reset.

Sensitivity analysis for interest rate risk in the banking book

At 31 December 2018

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	20	8	110	(3,318)	3,185	72	77
ISK, non-indexed	9	57	(7)	(193)	(77)	(1)	(212)
EUR	87	(25)	13	(1,605)	1,709	-	179
SEK	92	-	(16)	-	-	-	76
USD	(63)	-	-	-	-	-	(63)
Other	(1)	(11)	-	-	-	-	(12)
Total	144	29	100	(5,116)	4,817	71	45

At 31 December 2017

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	-	(48)	(280)	(2,833)	2,924	989	752
ISK, non-indexed	53	(34)	140	(334)	310	(2)	133
EUR	34	(45)	84	(102)	-	-	(29)
SEK	27	-	-	-	-	-	27
USD	4	(54)	-	-	-	-	(50)
Other	18	(18)	-	-	-	-	-
Total	136	(199)	(56)	(3,269)	3,234	987	833

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62. Currency risk

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 Group'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.

Currency analysis at 31 December 2018

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	377	250	135	23	10	54	51	88	29	73	1,090
Bonds and debt instruments	32,313	10,968	24	-	-	-	-	-	-	-	43,305
Shares and equity instruments	45	2,202	398	-	-	-	40	-	-	-	2,685
Loans to credit institutions	15,662	12,614	4,488	258	613	4,683	1,901	530	123	538	41,410
Loans to customers	105,852	31,603	2,037	734	3,213	2	4,318	572	5,710	39	154,080
Other assets	1,270	2,056	834	4	91	83	2	45	-	1,737	6,122
Total assets	155,519	59,693	7,916	1,019	3,927	4,822	6,312	1,235	5,862	2,387	248,692
Liabilities											
Deposits from credit institutions	5,622	538	83	-	96	-	16	-	-	-	6,355
Deposits from customers	26,605	26,819	4,293	329	430	927	3,211	1,728	434	144	64,920
Debt issued and other borrowed funds	113,670	-	-	-	-	41,764	-	-	-	-	155,434
Subordinated loans	-	-	-	-	-	16,216	-	-	-	-	16,216
Other liabilities	2,502	1,269	578	30	266	82	154	138	-	2,098	7,117
Total liabilities	148,399	28,626	4,954	359	792	58,989	3,381	1,866	434	2,242	250,042
Net on-balance sheet position	7,120	31,067	2,962	660	3,135	(54,167)	2,931	(631)	5,428	145	(1,350)
Net off-balance sheet position	(7,589)	(31,140)	(2,964)	(667)	(3,170)	54,350	(2,844)	642	(5,418)	(147)	1,053
Net position	(469)	(73)	(2)	(7)	(35)	183	87	11	10	(2)	(297)

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62. Cont'd

Currency analysis at 31 December 2017

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	238	124	78	19	5	39	30	60	26	39	658
Bonds and debt instruments	7,253	3,688	23	-	-	-	2,544	-	-	-	13,508
Shares and equity instruments	29	1,467	-	-	-	-	37	-	-	80	1,613
Loans to credit institutions	6,177	12,095	620	907	344	2,514	1,804	778	129	716	26,084
Loans to customers	92,179	19,693	2,287	1,220	3,198	3	4,791	673	4,166	47	128,257
Other assets	874	788	570	5	51	27	2	30	11	1,359	3,717
Total assets	106,750	37,855	3,578	2,151	3,598	2,583	9,208	1,541	4,332	2,241	173,837
Liabilities											
Deposits from credit institutions	2,366	378	-	4	4	-	-	-	-	-	2,752
Deposits from customers	25,396	24,405	4,468	190	336	703	2,683	2,452	358	22	61,013
Debt issued and other borrowed funds	87,166	-	-	-	-	7,660	6,391	-	-	-	101,217
Subordinated loans	-	-	-	-	-	9,505	-	-	-	-	9,505
Other liabilities	2,994	2,577	559	9	202	65	4	45	30	1,875	8,360
Total liabilities	117,922	27,360	5,027	203	542	17,933	9,078	2,497	388	1,897	182,847
Net on-balance sheet position	(11,172)	10,495	(1,449)	1,948	3,056	(15,350)	130	(956)	3,944	344	(9,010)
Net off-balance sheet position	11,492	(11,572)	1,466	(1,952)	(3,101)	15,390	(353)	1,022	(3,981)	(149)	8,262
Net position	320	(1,077)	17	(4)	(45)	40	(223)	66	(37)	195	(748)

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63. Sensitivity analysis for currency risk

The table below shows the effect of a 10% depreciation or appreciation of FX rates where the Group had positions at the reporting date, with all other variables held constant.

Sensitivity analysis for currency risk	31.12.2018		31.12.2017	
	Profit or (loss)			
Currency	-10%	10%	-10%	10%
EUR	47	(47)	(32)	32
USD	7	(7)	108	(108)
GBP	-	-	(2)	2
CHF	1	(1)	-	-
JPY	4	(4)	5	(5)
SEK	(18)	18	(4)	4
NOK	(9)	9	22	(22)
DKK	(1)	1	(7)	7
CAD	(1)	1	4	(4)
Other currencies	-	-	(20)	20
Total	30	(30)	74	(74)

64. Shares and equity instruments

The Group's equity exposure in the trading book arises from flow trading and market making with shares listed on the Nasdaq Iceland Stock Exchange. Shares and equity instruments in the banking book are classified as mandatorily at fair value through profit or loss or are classified as held for sale.

65. Sensitivity analysis for shares and equity instruments

The table shows how a 10% shift in equity prices would affect the Group's equity and net financial income. Securities used for hedging are excluded.

Sensitivity analysis for shares and equity instruments		31.12.2018		31.12.2017	
		Profit or (loss)			
Portfolio	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading book	10%	(123)	123	(174)	174
Banking book	10%	(639)	639	(508)	508
Total		(762)	762	(682)	682

66. Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. However, the Group is subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and collateral requirements. Other derivatives held for trading or for other purposes are insignificant.

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67. Inflation risk

The Group is exposed to inflation risk since the value of CPI-linked assets exceeds CPI-linked 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 affect profit and loss. A 1% increase in the index would lead to an ISK 120 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

Assets, CPI-linked	31.12.2018	31.12.2017
Bonds and debt instruments	2,721	2,442
Loans to customers	293,917	270,533
Off-balance sheet position	-	506
Total assets	296,638	273,481

Liabilities, CPI-linked		
Deposits from customers	95,917	92,077
Debt issued and other borrowed funds	118,103	91,351
Off-balance sheet position	70,617	62,569
Total liabilities	284,637	245,997
CPI imbalance	12,001	27,484

68. Capital management

The following table shows the capital base, risk exposure amount, the resulting capital ratios, and leverage for the Group at 31 December 2018 and 31 December 2017.

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through Act no. 161/2002 on Financial Undertakings and regulation no. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the Financial Supervisory Authority, published in October 2018, the overall capital requirement is 18.8%, increasing to 19.3% in May 2019 when the countercyclical buffer will increase by 0.5%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The minimum leverage ratio for Icelandic financial institutions is 3%.

	31.12.2018	31.12.2017
CET1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,499	6,179
Retained earnings	102,496	107,387
Non-controlling interests	2,318	2,479
Fair value changes due to own credit standing	376	-
Tax assets	(215)	(4)
Intangible assets	(5,002)	(4,231)
Other regulatory adjustments	-	(1,285)
Total CET1 capital	171,472	175,525
Tier 2 capital		
Qualifying subordinated liabilities	16,216	9,505
General credit risk adjustments	-	1,729
Total capital base	187,688	186,759

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68. Cont'd

	31.12.2018	31.12.2017
Risk exposure amount		
- due to credit risk	750,801	682,525
- due to market risk	7,622	8,102
Market risk, trading book	6,649	6,709
Currency risk	973	1,393
- due to credit valuation adjustment	2,385	1,534
- due to operational risk	85,141	83,331
Total risk exposure amount	845,949	775,492
Capital ratios		
CET1 ratio	20.3%	22.6%
Total capital ratio	22.2%	24.1%
Leverage ratio		
Exposure amount		
On-balance sheet exposures	1,120,637	1,026,879
Off-balance sheet exposures	47,119	51,328
Derivative exposures	8,935	6,334
Leverage ratio total exposure measure	1,176,691	1,084,541
Tier 1 capital	171,473	175,525
Leverage ratio	14.6%	16.2%

69. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Goup’s definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board has approved an Operational Risk Policy which outlines the Bank's framework for operational risk management.

Risk Management is responsible for implementing the Bank’s operational risk framework, for developing, maintaining the Operational Risk Policy and for communicating the policy to the Bank‘s employees.

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Notes to the Consolidated Financial Statements

Accounting policies

70. Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, short positions in listed bonds, derivative financial instruments and certain debt securities.

Non-current assets and disposal groups held for sale are measured at the lower of its carrying amount and fair value less costs to sell.

Recognised financial liabilities designated as hedged items in qualifying fair value hedge relationships are measured at amortised cost adjusted for changes in fair value attributable to the risk being hedged.

71. Changes in presentation

As a result of the application of IFRS 15, the Group has changed its presentation in the consolidated income statement as follows:
- Insurance and wholesale annual fees related to credit cards were presented as an expense in the line item "Fee and commission expense" before 1 January 2018 but they are presented as a deduction from revenue in the line item "Fee and commission income" from 1 January 2018. This change in presentation has no effect on the net fee and commission income.

72. Significant accounting policies

The accounting policies set out below have been applied consistently by the Group to the periods presented in these consolidated financial statements.

At 1 January 2018 the Group implemented IFRS 9 and elected not to restate comparative period information. Accordingly, comparative periods are presented in accordance with IAS 39 as described in the Group's audited consolidated financial statements for the year ended 31 December 2017.

Set out below is an index of the significant accounting policies, the details of which are available on the pages that follow.

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Notes to the Consolidated Financial Statements

72.1 Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries presented as those of a single economic entity. The Group consolidates its subsidiaries on the basis of control whereas subsidiaries are entities controlled by the Group.

Control

The Group controls an entity when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

The Group is exposed, or has rights, to variable returns from its involvement with an entity when the Group's returns from its involvement have the potential to vary as a result of the entity's performance.

The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the entity's returns.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

When the Group assesses whether it controls an entity, it also determines whether it is a principal or an agent. If the Group has the power to direct the activities of the entity to generate returns for itself, then it is a principal. If the Group is primarily engaged to act on behalf and for the benefit of other parties, then it is an agent and it does not control the entity when exercising its decision-making rights delegated to it. In assessing whether the Group is a principal or an agent it considers the overall relationship between itself, the entity and other parties involved with the entity. In particular, the Group considers the scope of its decision-making authority over the entity, the rights held by other parties, the remuneration to which it is entitled in accordance with any remuneration agreements and the Group's exposure to variability of returns from other interests that it holds in the entity. Different weightings are applied to each of these factors on the basis of particular facts and circumstances.

The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to one or more of the elements of control.

Funds management

The Group acts as a fund manager or an investment adviser for investment funds. The purpose of these investment funds is to earn commission income from asset management for third parties. Such investment funds are financed by issuing unit holdings to investors. The Group does not have any contractual financial responsibility with respect to such custom units. The funds are not consolidated unless they are under the control of the Group.

The Group reviews all the facts and circumstances in order to decide if an investment fund should be consolidated. The Group is deemed to be a principal and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or guarantee, and is able to influence the returns of the funds by exercising its power.

Consolidation

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group loses control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities are eliminated in full on consolidation. The carrying amount of Íslandsbanki's investment in each subsidiary and Íslandsbanki's portion of equity of each subsidiary are eliminated and any related goodwill is recognised as an asset.

When the Group is committed to a sale plan involving the loss of control of a subsidiary and the criteria for classification as held for sale are met (see Note 72.11), it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements. This is regardless of whether the Group will retain a non-controlling interest in the subsidiary after the sale.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 72.24), the Group presents the gain or loss from disposal in the income statement in the line item "Profit (loss) from discontinued operations, net of income tax".

If the Group loses control of a subsidiary, it derecognises the related assets (including goodwill), liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss. Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

72.1 Cont'd

Non-controlling interests

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination, the Group measures at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

The Group presents non-controlling interests within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki and to non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

When the proportion of the equity held by non-controlling interests changes, the Group adjusts the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to equity holders of Íslandsbanki hf. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

Business combinations and goodwill

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

72.2 Foreign currencies

The financial statements of each of the Group's entities are measured using the functional currency of the respective entity.

Transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into functional currencies at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, adjusted for effective interest and payments during the year, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the year.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the functional currency at the spot exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognised in profit or loss (see Note 72.19).

72.3 Financial assets and financial liabilities

Recognition

The Group recognises a financial asset or a financial liability in its statement of financial position on the trade date, which is the date on which the Group becomes party to the contractual provisions of the instrument, except for loans which are recognised on the date when cash is advanced by the Group to the borrowers. At initial recognition, the Group measures a financial asset or a financial liability at its fair value plus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability.

Derecognition

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

The Group derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

72.3 Cont'd

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

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

The Group does not derecognise from its statement of financial position securities which the Group sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Modifications

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value.

Classification and measurement

Financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories (see also Note 6):
• Financial assets measured at amortised cost
• Financial assets at fair value through other comprehensive income
• Financial assets at fair value through profit or loss, either as:
  - financial assets mandatorily at fair value through profit or loss; or
  - financial assets designated as at fair value through profit or loss
• Derivative assets held for hedging

The measurement basis of individual financial assets is determined based on an assessment of the cash flow characteristics of the assets and the business models under which they are managed.

The business models

The business models are determined by the Group's key management personnel in the way that assets are managed and their performance is reported to them. The Group determines its business models at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. This condition is not an instrument-by-instrument approach to classification, but is determined at a higher level of aggregation. The Group's business models fall into the following three categories: Held to collect, Held to collect and for sale, and Other fair value business models, where assets are held for trading or managed on a fair value basis and are neither Held to collect nor Held to collect and for sale.

Solely payments of principal and interest (SPPI)

Financial assets held within the business models Held to collect and Held to collect and for sale, are assessed to evaluate if their contractual cash flows are comprised of solely payments of principal and interest. SPPI payments are those which are consistent with a basic lending arrangement. Principal is the fair value of the financial asset at initial recognition and changes over the life of the financial asset, for example if there are repayments of principal. Interest relates to basic lending returns, including compensation for the time value of money and credit risk associated with the principal amount outstanding over a period of time. Interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs), as well as a profit margin that is consistent with a basic lending arrangement.

Where the contractual terms introduce exposure to risk or variability of cash flows that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

72.3 Cont'd

Financial assets measured at amortised cost

A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows, i.e. Held to collect.

Financial assets at amortised cost are measured using the effective interest method. Amortised cost is calculated by taking into account the amount at which the assets are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment. Accrued interest is included in the carrying amount of the financial asset in the statement of financial position.

Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

Financial assets at fair value through other comprehensive income (FVOCI)

For shares and equity instruments that are not held for trading, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. This election is made on an instrument-by-instrument basis. Shares and equity instruments at FVOCI are not subject to an impairment assessment. Dividends are to be presented in profit or loss, as long as they represent a return on investment. On derecognition there is no recycling of fair value gains and losses to profit or loss.

Financial assets at fair value through profit or loss (FVTPL)

Financial assets classified at fair value through profit or loss are all other financial assets which are not classified at amortised cost or at fair value through other comprehensive income. This includes financial assets classified mandatorily at fair value through profit or loss and financial assets which are irrevocably designated by the Group at initial recognition as at fair value through profit or loss that would otherwise meet the requirements to be measured at amortised cost or at FVOCI. The Group designates financial assets as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise. During the year the Group did not classify any financial assets as designated at fair value through profit or loss.

Financial assets at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned, which is recognised in the line item "Interest income" and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)".

Derivative assets held for hedging

Derivative assets held for hedging consist of derivatives with positive fair value which are designated and accounted for as hedging instruments (see Note 72.5).

Financial liabilities

For the purpose of measuring its financial liabilities, the Group classifies them at inception in one of the following categories (see also Note 6), except for loan commitments and financial guarantees (see Note 72.12):

- Financial liabilities measured at amortised cost
- Financial liabilities mandatorily at fair value through profit or loss
- Financial liabilities designated as at fair value through profit or loss
- Derivative liabilities held for hedging

Financial liabilities measured at amortised cost

Financial liabilities measured at amortised cost are non-derivative financial liabilities. Financial liabilities measured at amortised cost include deposits, debt issued and other borrowed funds, and subordinated loans.

Financial liabilities measured at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums and fees and costs that are an integral part of the effective interest rate). Accrued interest is included in the carrying amount of the liabilities in the statement of financial position.

72.3 Cont'd

The amortised cost of certain bonds issued by the Group, which are designated as hedged items in qualifying fair value hedge relationships, is adjusted for changes in the fair value of the bonds attributable to interest rate risk (see Note 72.5).

Financial liabilities mandatorily at fair value through profit or loss

Financial liabilities mandatorily at fair value through profit or loss are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities mandatorily at fair value through profit or loss consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities mandatorily at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Financial liabilities designated as at fair value through profit or loss

Financial liabilities designated as at fair value through profit or loss are recognised at fair value and changes in fair value attributable to changes in the credit risk of those liabilities are recognised in other comprehensive income and are not subsequently reclassified to profit or loss. The remaining fair value changes are included in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" using the effective interest rate method and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

The Group calculates the fair value attributable to changes in credit risk as the difference between the changes in fair value of the financial liability and the amount of changes in fair value attributable to changes in market interest rates. The change in fair value attributable to changes in market interest rates on financial liabilities is calculated by discounting contractual cash flows at the end of the period with the discount rate of the appropriate market interest rate.

Upon initial recognition, the Group determines if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, if applicable the whole fair value change is presented in profit or loss.

Derivative liabilities held for hedging

Derivative liabilities held for hedging consist of derivatives with negative fair value which are designated and accounted for as hedging instruments (see Note 72.5).

Reclassification

Financial assets are reclassified between measurement categories if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the Group's operations.

Financial liabilities are not reclassified.

Offsetting financial assets and financial liabilities

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

Determination of fair value

The fair value of a financial instument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the reporting date.

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which observable market prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate.

Periodically, the Group tests the valuation techniques and calibrates against historical data and using prices from observable current market transactions for the same instrument, or based on other available observable market data.

Changes in the fair value of financial assets and financial liabilities are recognised in profit or loss in the line item "Net financial income (expense)".

72.3 Cont'd

The Group has an established control framework with respect to the measurement of fair values. The business unit owning the positions is responsible for their valuations and for submitting the valuation to the Bank's Investment Committee for approval. Risk Management provides an independent review of the results, the valuation methods used and of the use of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's Investment Committee.

Impairment of financial assets

The adoption of IFRS 9 has had a significant impact on the Group's impairment methodology. The two main reasons for this impact are firstly that the impairment model of IFRS 9 is forward-looking as opposed to the incurred loss model of IAS 39 and secondly that impairment under IFRS 9 should reflect a probability weighted average of possible outcomes in contrast to IAS 39 where the single most likely outcome was accounted for. In addition, the expected credit loss model in IFRS 9 employs a dual measurement approach, under which the loss allowance for expected credit losses (ECL) is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk (SICR) of the financial instrument since initial recognition. To satisfy the provisions of the IFRS 9 standard, a significant amount of modelling must be involved. The models which the Group uses for the calculation of the impairment amount are developed according to the Group's modelling framework. This framework imposes structure on the initial model development work, the model documentation including educational material as needed for users, the approval process for models, the implementation of models and the lifetime support for models, including validation and back-testing. The Group's impairment process, which encompasses all the steps needed to derive the appropriate impairment allowance for each accounting period, is documented and approved by the All Risk Committee.

Stage assignment

At each reporting date, all assets subject to the impairment methodology must be divided into three groups, termed "Stages", reflecting the extent of credit deterioration since initial recognition. This division then has an effect on how the impairment is measured and how interest is recognised.

Stage 1 – All assets that have not experienced a SICR are assigned to Stage 1. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from credit events occurring within 12 months of the reporting date (12-month ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 2 – Assets that the Group determines to have experienced a SICR, but are not credit-impaired, are classified as Stage 2. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from all credit events occurring within the expected lifetime of the assets (lifetime ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 3 – This Stage is for assets which are credit-impaired according to the Group's assessment. These assets are therefore experiencing an ongoing credit event. Thus, the 12-month ECL and lifetime ECL are the same amount and this amount is recognised as impairment allowance. For assets in this Stage, interest is recognised on the gross carrying amount of assets, net of impairment allowance.

The Group's definition of being credit-impaired is on a customer level, rather than on the level of an individual asset. According to the definition, a customer is credit-impaired when either of the following holds:
a) The Group assesses that it is unlikely that the customer can service all of their commitments to the Group in accordance with the terms of the agreements without recourse to default provisions in the agreements or
b) The customer is more than 90 days past due on any of their commitments

The assessment in point a) is made based on a defined set of triggers, which includes serious breach of covenants, serious registrations on an internal watchlist, initiation of serious collection actions and serious external credit related information.

Furthermore, there is a defined set of conditions which must be satisfied so that customers that have been assessed as being credit-impaired are no longer subject to this assessment. This includes probation periods and a view to the future outlook of the customer.

The Group's definition of a SICR is on the level of an individual asset. The Group assesses that there has been a significant increase in credit risk of an asset if the probability of a credit impairment event, i.e. transfer to Stage 3, occurring over the lifetime of the asset has increased significantly from the origination of the assets. For this purpose, origination does not refer to any modification events which have not resulted in derecognition of the asset. The assessment is based on a defined set of triggers. This includes, as a backstop, the trigger that the asset is more than thirty days past due. Other triggers are internal assessments of outlook, events such as forbearance events which are less severe than a credit event, external credit related information and a significant deterioration in risk assessment compared with the risk assessment done in relation to the origination of the asset. The definition of SICR depends only on the probability of a credit event occurring, it does not take into account collateralisation or any other information related to the expected loss arising from the event.

72.3 Cont'd

The Group does not employ the low credit risk exemption in the Stage assignment process. In alignment with its operating procedures, the Group has chosen as its accounting policy to measure the impairment allowance for lease receivables at an amount equal to the lifetime ECL only for those assets which have a SICR or are credit-impaired. For other lease receivables the impairment allowance is equal to the 12-month ECL.

Expected credit loss (ECL)
The ECL for each asset is calculated using models for the probability of a credit impairment event occurring (PD), the loss percentage expected in case of such an event (LGD) and the outstanding amount at the time of the event (EAD). In its simplest form the ECL can be calculated as the product of these factors, however, for several reasons, the actual formula must be more complicated than this.

The Group uses the standardised approach for regulatory capital purposes but has used PD models and LGD models for risk management purposes for several years. These models have been adapted for IFRS 9 purposes. For EAD, and for LGD to a certain extent, new models have been developed.

The PD models are either fully automated statistical models, expert models or hybrid. For the models with a component involving expert input there is a process in place to ensure proper review of the model outcome and periodic reassessment of obligors. The inputs into the models include demographic variables, information from financial statements and past payment behaviour, among other variables.

The effects of the economy on the PD is accounted for through the use of scaling factors which map through-the-cycle PD values to point-in-time PD values. The Group has a model to predict these scaling factors based on economic forecasts. The economic forecasts used are provided at least quarterly by the Group's Chief Economist and approved by the All Risk Committee. The Group uses several economic scenarios which have different scaling factors in order to represent the whole range of possible future economic developments. The actual impairment allowance is the weighted average of the ECL in these different scenarios.

The LGD model considers several scenarios for how a facility may develop once a credit event has occurred. One possibility is that the facility cures without a loss. If not, the recoveries may be based on the seizing of collateral and to estimate such recoveries it is appropriate to consider several scenarios for the development of the value of the collateral. Finally, there may be recoveries even though a formal collateral is not in place. These different recovery scenarios are weighted differently depending on the economic scenario under consideration. This leads to a non-linear interaction and thus a difference between the probability weighted average ECL and the ECL in the most likely scenario.

For EAD it is necessary to account for expected prepayments on term loans and for the expected utilisation of commitments such as credit cards, overdrafts, financial guarantees and credit lines. The expected lifetime of agreements may also extend beyond the contractual lifetime for contracts which are generally extended.

Write-off policy
The Group writes off a financial asset, either partially or in full, when there is no realistic prospect of recovery. Where financial assets are secured, write-off is generally after receipt of any proceeds from the realisation of security. In subsequent periods, any recoveries of amounts previously written off are credited to the consolidated income statement.

The impairment process
In the Group's impairment framework, the Stage assignment and ECL for each financial asset is calculated from the aforementioned models. The outcome is reviewed by the business units and they can propose changes if they provide sufficient supporting material. The impairment and any proposals for changes are reviewed by an Impairment Council appointed by the All Risk Committee and the impairment allowance is approved by the All Risk Committee on a quarterly basis.

The principle of materiality applies to the above discussion on impairment, whereby exceptions related to non-materiality and immaterial adjustments are not discussed.

72.4 Derivative financial instruments

Derivatives are primarily used in trading activities but are also used to manage the Group's exposure to various risks, such as interest rate risk, inflation risk and currency risk. Derivatives which do not classify as equity instruments of the Group are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities).

When derivatives are embedded in other financial instruments or host contracts, such combinations are known as hybrid instruments with the effect that some of the cash flows of a hybrid instrument vary in a way similar to a stand-alone derivative. These embedded derivatives are measured and presented in the consolidated financial statements as if they were free-standing derivatives.

72.4 Cont'd

The Group accounts for an embedded derivative seperately from the host contract when, the host contract is not an asset in the scope of IFRS 9, is not carried at fair value through profit and loss, the terms of the embedded derivative would meet the definition of a derivative if they were contained in a separate contract, and the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract. When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

The Group applies hedge accounting. Accordingly, some of the Group's derivative financial assets and liabilities are accounted for as financial assets or financial liabilities mandatorily at fair value through profit or loss while others are accounted for as derivative assets or liabilities held for hedging (see Note 72.3 and Note 72.5).

72.5 Fair value hedge accounting

The Group applies fair value hedge accounting with respect to designated hedging relationships consisting of certain fixed-rate euro denominated bonds as the hedged items and certain euro denominated interest rate swaps as the hedging instruments, whereby the Group pays floating rate interest and receives fixed rate interest. The hedging relationships are designated and accounted for as fair value hedges because the interest rate swaps are hedging the exposure of the Group to changes in the fair value of the bonds arising from changes in interest rates. The Group recognises the changes in the fair value of the interest rate swaps immediately in profit or loss together with the changes in the fair value of the bonds which are attributable to the interest rate risk. The changes in the clean fair value of the swaps and the notes are included in the line item “Net financial income (expense)”, the accrued interest on both the notes and the swaps is included in the line item “Interest expense” and foreign exchange gains and losses on the notes are included in the line item "Net foreign exchange gain (loss)".

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80-125%.

If a hedging derivative expires or is sold, terminated or exercised, or a hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting for the corresponding hedging relationship is discontinued prospectively. Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

72.6 Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash on hand, demand and term deposits with the Central Bank and with other credit institutions, short-term loans to credit institutions. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, that are subject to an insignificant risk of changes in their fair value and which are used by the Group in the management of its short-term cash commitments.

72.7 Investments in associates

Associates are entities over which the Group has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies. If the Group holds at least 20% of the voting power of an entity, or potential voting rights, it is presumed that the Group has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the Group holds less than 20% of the voting power of an entity, it is presumed that the Group does not have significant influence, unless such influence can be clearly demonstrated.

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. The carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets of the associate since the acquisition date. Goodwill relating to acquisitions of associates is included in the carrying amount of the investments and is not tested for impairment separately.

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases.

When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

72.7 Cont'd

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and the impairment loss is recognised in profit or loss.

Upon loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

Income and expenses from investments in associates are recognised in profit or loss in the line item "Other operating income".

72.8 Property and equipment

Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses (see Note 72.21).

Where parts of an item of property and equipment have different useful lives, those components are accounted for and depreciated as separate items of property and equipment.

Subsequent costs

The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred, if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. All other costs are recognised in profit or loss as incurred.

Depreciation

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. The depreciable amount of each item of property and equipment is determined after deducting its residual value. Depreciation is expensed in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property and equipment.

The estimated useful lives are as follows:

Buildings	50 years
Fixtures	6-12 years
Equipment	4-5 years
Vehicles	3 years

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

72.9 Intangible assets

Software

Software acquired by the Group is measured at cost less accumulated amortisation and impairment losses.

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and impairment.

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

Software is amortised on a straight-line basis in profit or loss over its estimated useful live, from the date that it is available for use. The estimated useful life of software is four to ten years.

Goodwill

The Group recognises any goodwill arising from a business combination as an asset and measures it initially at cost, being the positive difference between (a) the aggregate of the consideration transferred, the amount of any non-controlling interest and the acquisition-date fair value of the Group's previously held equity interest in the acquiree and (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed by the Group.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is tested by the Group for impairment annually or whenever there is an indication that it may be impaired.

72.10 Leases

The Group classifies leases based on the substance of the arrangements and the extent of the transfer of risks and rewards incidental to ownership of leased assets. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

Group as a lessee
Lease payments under operating leases where the Group is the lessee are recognised as an expense on a straight-line basis over the capital lease term in the line item "Other operating expenses".

Group as a lessor
When the Group is the lessor in a capital lease, the Group recognises a receivable equal to the net investment in the lease and presents it in the line item "Loans to customers" in the statement of financial position. The Group applies its accounting policies for derecognition and impairment of financial assets also to its capital lease receivables. The Group recognises the finance income from capital lease receivables in profit or loss in the line item "Interest revenue" over the period of the capital lease so as to give a constant periodic rate of return on the net investment in the capital lease.

When the Group is lessor in arrangements which involve the legal form of capital leases, but which in substance do not involve leases, the Group classifies them within loans at amortised cost.

72.11 Non-current assets and disposal groups held for sale

Non-current assets and disposal groups are classified as held for sale and presented in separate line items in the statement of financial position if the Group expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable.

Immediately before the initial classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable accounting policies. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets and investment properties, which are measured in accordance with the accounting policies of the Group applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment is no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Group applicable to those liabilities.

Income and expenses of non-current assets and disposal groups held for sale are recognised in profit or loss in the line item "Profit (loss) from discontinued operations, net of income tax" (see Note 72.24).

72.12 Loan commitments and financial guarantees

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. In 2017 the Group recognised a provision for loan commitments only when the Group was committed to providing a loan that would be considered to be impaired or when the commitment became onerous. From 1 January 2018, under IFRS 9, these contracts are in the scope of the ECL requirements (see Note 72.3). Expected credit loss of loan commitments is recognised in the statement of financial position in the line item "Other liabilities". Loan commitment fees received by the Group are recognised in profit or loss in the line item "Fee and commission income".

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities.

Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received. In 2017 the liabilities were subsequently carried at the higher of the amount representing the initial fair value amortised over the life of the guarantee and the best estimate of the expenditure required to settle the liability when a payment under the contracts had become probable. From 1 January 2018, under IFRS 9, the liabilities were subsequently carried at the higher of the amount representing the initial fair value amortised over the life of the guarantee and the ECL allowance (see Note 72.3).

Any changes in the liabilities arising from financial guarantees are recognised in profit or loss. The premium received is recognised in profit or loss in the line item "Fee and commission income".

72.13 Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the reporting date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that the reimbursement will be received and the amount of the receivable can be measured reliably.

The Group recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

72.14 Employee benefits

All Group entities are required to pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid by the Group. The Group recognises these contributions as salary related expenses when they become due. The Group does not have a defined benefit pension plan.

Short-term employee benefits include salaries, short-term cash bonuses, social security contributions, short-term compensated absences and non-monetary benefits for current employees. Short-term employee benefit obligations are expensed by the Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

72.15 Equity

Share capital

The share capital disclosed in the consolidated financial statements represents the total nominal value of ordinary shares issued by the parent company. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

Dividends on shares

Dividends payable to shareholders of the parent company are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders at the parent company's annual general meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

Restricted reserves

The Group is to transfer, if applicable, certain amounts from retained earnings to restricted reserves which can therefore not be distributed as dividends to shareholders. These restricted reserves are specified as follows:

Restricted reserve due to capitalised development cost

When the Group capitalises development cost it transfers a corresponding amount from retained earnings to a restricted reserve. In the future the restricted amount is to be transferred back to retained earnings as the capitalised development cost is amortised in profit or loss.

Restricted reserve due to fair value changes of financial assets

The Group transfers fair value changes of financial assets at fair value through profit or loss, net of tax if applicable, from retained earnings to a restricted reserve. Amounts recognised in the reserve are transferred back to retained earnings upon sale of the financial asset.

Restricted reserve due to unrealised profit of subsidiaries and associates

If share of profit of a subsidiary or an associated company is in excess of dividend received or which can be claimed, the Group transfers the difference to a restricted reserve in equity. If the Group's shareholding in a subsidiary or an associate is sold or written off the applicable amount recognised in the reserve is transferred to retained earnings.

72.15 Cont'd

Fair value reserve

Fair value reserve comprises all unrealised gains or losses related to fair value changes of equity instruments classified at fair value through other comprehensive income. On derecognition of the equity instruments fair value changes are not reclassified to profit and loss.

Liability credit reserve

Changes in fair value attributable to changes in the credit risk of financial liabilities designated as at fair value through profit or loss are recognised in other comprehensive income and are not subsequently reclassified to profit or loss.

Other reserves

Other reserves consist of statutory reserve and translation reserve.

Statutory reserve

According to the Act on Public Limited Companies no. 2/1995 the statutory reserve shall amount to 25% of the share capital of the Bank.

Translation reserve

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

72.16 Interest income and interest expense

For all financial assets and financial liabilities measured at amortised cost, interest income and interest expense is recognised in profit or loss using the effective interest method. For financial assets and financial liabilities at fair value through profit and loss, interest income and interest expense is recognised through profit or loss on an accrual basis, except for financial liabilities at fair value through profit or loss (see Note 72.3).

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro denominated bonds issued by the Group (see Note 72.5), is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or interest expense. For floating rate instruments, interest income or interest expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate.

Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset. For financial assets in Stage 1 and Stage 2 interest is recognised on the gross carrying amount of the assets and for financial assets in Stage 3 interest is recognised on the gross carrying amount of the assets, net of impairment allowance (see Note 72.3).

Interest income and interest expense include gains and losses on derecognition of financial assets and financial liabilities measured at amortised cost.

72.17 Net fee and commission income

Fees and commissions are recognised to reflect the transfer of services to customers at an amount that reflects the consideration that is expected to be received for such services. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised in profit or loss on a straight-line basis over the commitment period.

72.17 Cont'd

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses, are recognised on completion of the underlying transaction.

Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria is fulfilled.

Where it is assessed that the Group is acting as an agent, the consideration is presented on a net basis.

72.18 Net financial income (expense)

Net financial income (expense) consists of net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss, net gain (loss) on financial liabilities designated as at fair value through profit or loss and net gain (loss) on fair value hedges.

Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss
Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets and financial liabilities classified by the Group as mandatorily at fair value through profit or loss, except for interest income and interest expense, which are included in the line items "Interest income" and "Interest expense", and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)". Dividend income from financial assets is recognised in the income statement when the Group's right to receive payment is established.

Net gain (loss) on financial liabilities designated as at fair value through profit or loss
Net gain (loss) on financial liabilities designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial liabilities designated by the Group as at fair value through profit or loss, except for changes in fair value attributable to changes in credit risk which is recognised in other comprehensive income, interest incurred which is recognised as "Interest expense" on an accrual basis, and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Net gain (loss) on fair value hedges
Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are designated and accounted for as hedging instruments in fair value hedges and the changes in the fair value of certain bonds issued by the Group, which are attributable to the interest rate risk of the bonds (see Note 72.5).

72.19 Net foreign exchange gain (loss)

Net foreign exchange gain (loss) disclosed as a separate line item in the income statement comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous financial statements.

Net foreign exchange gain (loss) also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured by the Group at fair value in foreign currencies.

72.20 Operating expenses

Operating expenses consist of professional services, depreciation of property and equipment, amortisation of intangible assets and other operating expenses, such as housing costs, advertising expenses and information system related expenses.

72.21 Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

An impairment loss is recognised in profit or loss if the carrying amount of an asset or cash-generating unit exceeds its estimated recoverable amount.

An impairment loss for non-financial assets is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

72.22 Bank tax

Bank tax is a tax on credit institutions which stated purpose is to create revenue for the Icelandic Government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, the tax is intended as a deterrent to increased risk appetite. The Bank tax is 0.376% of total liabilities in excess of ISK 50,000 million and is shown in a separate line in the income statement.

72.23 Income tax

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations. Income tax from discontinued operations is included in the line item "Profit (loss) from discontinued operations, net of income tax" in the income statement (see Note 72.24).

Income tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the Group recognises it in other comprehensive income or directly in equity, consistent with the recognition of the underlying item to which it relates.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is calculated based on temporary differences between the carrying amounts of assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration any tax loss carry forwards. This difference is due to the fact that tax assessments are based on premises that differ from those governing the financial statements, mostly because revenues, especially of financial assets, are recognised earlier in the financial statements than in the tax return.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. A deferred tax asset is reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantially enacted at the reporting date.

Tax assets are included in the line item "Other assets" and deferred tax liabilities are included in the line item "Tax liabilities" in the statement of financial position. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 72.11) are included in the line items "Non-current assets and disposal groups held for sale" and "Non-current liabilities and disposal groups held for sale", respectively, in the statement of financial position.

Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

72.24 Profit (loss) from discontinued operations

The profit or loss from discontinued operations consists of (i) the post-tax profit or loss from discontinued operations, (ii) loss recognised on the measurement to fair value less costs to sell in excess of book value of discontinued operations, (iii) profit or loss on the disposal of discontinued operations and (iv) the post-tax profit or loss from the sale of foreclosed assets held for sale.

72.25 Offsetting income and expenses

The Group presents income and expenses on a net basis in the income statement only when required or permitted under IFRSs.

72.26 Earnings per share

The Group presents basic and diluted earnings per share (EPS) for its ordinary shares. Basic EPS are calculated by dividing the profit or loss attributable to ordinary shareholders of the Group by the weighted average number of ordinary shares outstanding during the period. Diluted EPS are determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

72.27 Segment reporting

An operating segment is a distinguishable component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segment is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. 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.

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