Íslandsbanki

Consolidated Financial Statements 2012

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Endorsement and Statement by the Board of Directors and the CEO

The consolidated financial statements of Íslandsbanki hf. for the period ended 31 December 2012 comprise the Financial Statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Bank".

Operations and ownership

Íslandsbanki, with roots tracing back to 1884, is a universal bank offering Icelandic households, SMEs, investors and corporations comprehensive financial services. With assets of ISK 823 billion, at the reporting date, Íslandsbanki forms one of the country's largest banking and financial services groups. The Bank has a 20%-40% market share across all domestic franchise areas and operates an efficient branch network in Iceland. Building on a heritage of lending to industry in Iceland, the Bank has developed specific expertise in selected industry sectors; tourism, seafood, municipalities and energy.

The Bank is divided into six business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury and Subsidiaries & Equity Investments. At the reporting date there were 1,287 full-time employees at the Bank, thereof 1,079 were employees of the parent company.

Íslandsbanki has two owners; ISB Holding ehf., which owns 95% of the Bank´s share capital, and the Icelandic State Treasury which owns 5%. ISB Holding ehf. is owned by a subsidiary of Glitnir hf. (GLB Holding ehf.).

Six Board members are appointed by ISB Holding ehf. One Board member is appointed by the Icelandic State Financial Investments (ISFI - Bankasýsla ríkisins) which manages the Icelandic State Treasury's holdings in financial undertakings.

Risk Management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations. 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. The Bank's risk management framework and policies are discussed under Notes 60-83.

The reporting period

2012 was an eventful year for Íslandsbanki and important milestones were passed. The year will always be notable in the Bank's history as the year that the merger of Íslandsbanki and Byr was completed. The merger increased the Bank's market share significantly and set the scene for future income and synergy effects which started to emerge in 2012, but will be fully realised in 2013.

At year end 2011, the Bank announced its intention to merge with its 100% owned subsidiary Kreditkort hf., a credit card company offering MasterCard and American Express in Iceland. The merger was approved by the Icelandic Financial Supervisory Authority (FME) on 30 March 2012 and the merger subsequently became effective on 1 April 2012. The Bank will continue to use the brand name Kreditkort for credit card operations.

In December 2012, the Bank acquired the management of a private pension plan „Framtidaraudur" from the financial services firm Audur Capital. „Framtídaraudur" has merged with the Bank's private pension plan, that concurrently was rebranded to „Framtidaraudur VÍB". The merger will strengthen VÍB, the Bank's wealth management division, as well as broadening the Bank's pension savings offering to individual clients.

Fee and commission income has increased year on year, in part because of an increase in activity in Icelandic capital markets and more demand for corporate finance advisory. There are clear signs that the financial markets are more active now than in recent years. Íslandsbanki continued to play a leading role in the rebuilding phase of the Icelandic capital markets during the year. The Bank managed the bond offering of Eik, a real-estate company, which was the largest private sector bond offering since late 2008 and marks a breakthrough in corporate financing. Furthermore, the Bank oversaw the listings of Eimskip hf. and Fjarskipti hf. (Vodafone) on the NASDAQ OMX Iceland Stock Exchange, and is working on listings of other Icelandic companies.

Endorsement and Statement by the Board of Directors and the CEO

Demand for new loans is increasing and new lending to households and corporations has risen during the year, mainly in mortgages and asset-based financing.

The Bank continued with its funding diversification strategy by issuing ISK 9.4 billion of covered bonds during 2012 from its covered bond programme which was inaugurated in December 2011. The covered bonds have been well received by domestic investors. The Bank estimates that it will issue between ISK 10–13 billion annually to broaden its funding base.

In line with the Bank's strategy to reduce its holdings in companies in unrelated businesses Íslandsbanki sold, during the year, stakes in Icelandair and Vördur insurance amongst others.

Over the course of 2012, The Icelandic Supreme Court ruled on two specific cases regarding illegal foreign currency denominated loans, and again in January 2013. Based on these rulings, the Bank has commenced recalculations of the affected loans. The Bank has endeavoured to work with its customers in restructuring in such a way as to ensure that they continue as performing customers. Since the Bank´s establishment around 21,000 individuals and 3,660 corporations have received write-offs, debt forgiveness or some form of debt correction totalling ISK 463 billion.

In June, the EFTA Surveillance Authority (ESA) approved the measures taken in 2008 when Íslandsbanki was founded on the domestic operations of its predecessor Glitnir with support from the Icelandic State, pronouncing these measures as compatible with EEA rules. Íslandsbanki was the first bank in Iceland to receive such ESA approval, which helps confirm that the Bank is on the right track. Íslandsbanki constantly monitors its key business segment markets and developments in customer perception, by commissioning market research firms to conduct regular surveys in order to be able to respond to prevailing trends. Historical results have been very positive for Íslandsbanki as the Bank generally scores highly in key areas of customer perception.

Outlook

There have been several encouraging developments in the Icelandic economy in recent months. However, the improvement is relatively fragile, and can still be affected by the uncertainties still present both in Iceland and in the general environment internationally.

The economic recovery which began in Iceland in 2010 has continued throughout 2011 and 2012, in spite of difficulties in many neighbouring countries and various systemic problems still facing the Icelandic economy in the wake of the 2008 collapse. Output growth has been broadly based and is sufficient to reduce the margin of spare capacity in the economy. Driven by private consumption, investment, and exports, output growth has been close to the 30-year average. Increases in real wages, historically low interest rates, private sector debt forgiveness, rising real estate prices, and a low real exchange rate, reduced unemployment and job creation have all contributed to the economic recovery.

A variety of hindrances to growth still remain. Chief among them are the capital controls, the most pressing and complex economic and political problem facing the authorities at present. Although the capital controls provided stability in the foreign exchange market at a critical time, they will most likely slow growth in the long-term. The authorities aim to lift them, but the timing is undetermined, as is the exchange rate policy that might take effect afterwards. The large amount of foreign capital currently tied up in Icelandic krónur is the single largest obstacle to the rapid lifting of the capital controls.

Endorsement and Statement by the Board of Directors and the CEO

Accounting convention

The consolidated financial statements for the year ended 31 December 2012 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Profit from the Bank's operations for the year ended 31 December 2012 amounted to ISK 23,418 million, which corresponds to a 17.2% return on equity. The Board of Directors oft he Bank proposes that up to 30% of net profit will be paid in dividends to shareholders, but otherwise the profit will be added to the Bank's equity. The Board may convene a special shareholder meeting later in the year where a proposal regarding payment of dividends of profit for the previous fiscal years could be suggested.. Bank equity, according to the consolidated statement offi nancial position, amounted to ISK 147,660 million at year end. The Bank's total capital ratio, calculated according to the Act on Financial Undertakings, was 25.5%. The Board of Directors refers to Note 82 for further understanding oft he capital requirements of the Bank. The Bank's total assets amounted to ISK 823,375 million at year end 2012.

During 2012, the Bank decided to reward individuals which have kept up with their payment terms on mortgages and other term loans by reimbursing interest payments of ISK 2,493 million. The reimbursement ofi nterest payments, which took place on 25 February 2013, was made into individual savings accounts with a 30 days withdrawal restriction. The Bank hopes that this gesture will lay the foundation for future savings, or reduce the debt burden of households. The amount is reflected in these consolidated financial statements.

The Board of Directors draws special attention to the risks relating to the political and legal environment in Iceland where capital controls are still in place. Supreme Court rulings have affected the operations oft he Bank and added to the uncertainty of how to value part oft he loan portfolio. The Bank has made appropriate provisions in the financial statements 2012 to reflect the risk associated with those court rulings. The Board also notes that the Bank maintains a strong capital base and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 2.1 and 59 for the principal risks and uncertainties currently faced by the Bank.

To the best of our knowledge, these consolidated financial statements provide a true and fair view oft he Bank's operating profits and its financial position at 31 December 2012. It also describes the principal risks and uncertainties currently faced by the Bank.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's consolidated financial statements for the period 1 January to 31 December 2012 by means of their signatures.

Reykjavík, 27 February 2013

Board of Directors:

Chief Executive Officer:

Independent Auditors' Report

To the Board of Directors and Shareholders of Íslandsbanki hf.

We have audited the accompanying consolidated financial statements of Íslandsbanki hf., which comprise the consolidated statement of financial position as at 31 December 2012, consolidated income statement and consolidated statement of comprehensive income for the year 2012, consolidated statement of changes in equity and consolidated statement of cash flow for the year 2012, and a summary of significant accounting policies and other explanatory information.

Management's and the Board of directors Responsibility for the Consolidated Financial Statements
Management and the board of directors are responsible for the preparation and fair presentation oft hese consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation offi nancial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility
Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment oft he risks of material misstatement oft he consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation oft he consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness oft he entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the Consolidated Financial Statements give a true and fair view, oft he consolidated financial position of Íslandsbanki hf. as of 31 December 2012, and its consolidated financial performance and its consolidated cash flows for the period then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Confirmation of Endorsement and Statement by the Board of Directors and the CEO
Pursuant to the requirements of Item 5, Paragraph 1 of Article 106 oft he Icelandic Financial Statements Act No. 3/2006, we confirm to the best of our knowledge that the accompanying Endorsement and Statement by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statements Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Kópavogur 27 February 2013

Deloitte ehf.

Pálína Árnadóttir
State Authorised Public Accountant

Páll Grétar Steingrímsson
State Authorised Public Accountant

Consolidated Income Statement for the year 2012

	Notes	2012	2011
Interest income	10	57,714	52,671
Interest expense	10	(26,479)	(21,446)
Net interest income		31,235	31,225
Net valuation changes on loans and receivables	11	6,486	(1,296)
Provision for latent impairment		(776)	76
Net valuation changes		5,710	(1,220)
Net interest income after net valuation changes		36,945	30,005
Fee and commission income	12	14,812	8,698
Fee and commission expense	12	(5,353)	(2,732)
Net fee and commission income		9,459	5,966
Net financial income	13-15	2,655	2,649
Net foreign exchange gain	16	3,304	937
Other net operating income	17	996	894
Other net operating income		6,955	4,480
Total operating income		53,359	40,451
Administrative expenses	18-22	(24,589)	(19,870)
Impairment of goodwill	41	(425)	(17,873)
Contribution to the Depositors' and Investors' Guarantee Fund		(1,055)	(965)
Share of profit of associates net of tax	36	-	39
Profit before tax		27,290	1,782
Income tax	24	(6,253)	(75)
Bank tax	3.28	(858)	(682)
Profit for the year from continuing operations		20,179	1,025
Profit from discontinued operations, net of income tax	23	3,239	841
Profit for the year		23,418	1,866

The notes on pages 14 to 87 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2012 7 Amounts are in ISK million

Consolidated Statement of Comprehensive Income for the year 2012

	Notes	2012	2011
Profit for the year		23,418	1,866
Other comprehensive income			
Foreign currency translation differences for foreign operations	55	173	163
Other comprehensive income for the year (net of tax)		173	163
Total comprehensive income for the year		23,591	2,029
Profit attributable to:			
Equity holders of Íslandsbanki hf.		23,438	1,958
Non-controlling interests		(20)	(92)
Profit for the year		23,418	1,866
Total comprehensive income attributable to:			
Equity holders of Íslandsbanki hf.		23,611	2,073
Non-controlling interests		(20)	(44)
Total comprehensive income for the year		23,591	2,029
Basic earnings per share			
From continuing operations		2.02	0.11
From discontinued operations		0.32	0.08
From profit for the year	25	2.34	0.19
Diluted earnings per share			
From continuing operations		2.02	0.11
From discontinued operations		0.32	0.08
From profit for the year	25	2.34	0.19

The notes on pages 14 to 87 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2012 8 Amounts are in ISK million

Consolidated Statement of Financial Position as at 31 December 2012

	Notes	31.12.2012	31.12.2011
Assets			
Cash and balances with Central Bank	26	85,500	57,992
Derivatives	28	127	339
Bonds and debt instruments	29	64,035	58,662
Shares and equity instruments	30	10,445	11,107
Loans to credit institutions	31-32	54,043	43,655
Loans to customers	33-34	557,857	564,394
Investments in associates	36-37	503	1,070
Property and equipment	40	5,579	5,276
Intangible assets	41	261	544
Deferred tax assets	49-51	864	2,629
Non-current assets and disposal groups held for sale	42	39,046	42,690
Other assets	43	5,115	7,557
Total Assets		823,375	795,915
Liabilities			
Derivative instruments and short positions	28	18,435	13,373
Deposits from Central Bank	44	54	73
Deposits from credit institutions	44	38,218	62,772
Deposits from customers	45-46	471,156	462,943
Debt issued and other borrowed funds	47	66,571	63,221
Subordinated loans	48	23,450	21,937
Current tax liabilities	49-51	2,052	2,670
Deferred tax liabilities	49-51	20	17
Non-current liabilities and disposal groups held for sale	42	6,805	7,317
Other liabilities	53	48,954	37,889
Total Liabilities		675,715	672,212
Equity			
Share capital	54	10,000	10,000
Share premium	54	55,000	55,000
Other reserves	55	2,834	2,661
Retained earnings		78,571	55,133
Total equity attributable to the equity holders of Íslandsbanki hf.		146,405	122,794
Non-controlling interests		1,255	909
Total Equity		147,660	123,703
Total Liabilities and Equity		823,375	795,915

The notes on pages 14 to 87 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2012 9 Amounts are in ISK million

Consolidated Statement of Changes in Equity for the year 2012

	Notes	Attributable to equity holders of Íslandsbanki hf. Share capital	Share premium	Other reserves	Retained earnings	Total	Non-controlling interests	Total equity
Equity as at 31.12.2010		10,000	55,000	2,498	53,174	120,672	791	121,463
Translation differences for foreign operations	55			163		163		163
Net income recognised directly in equity		-	-	163	-	163	-	163
Profit for the year					1,958	1,958	(92)	1,866
Total comprehensive income for the year		-	-	163	1,958	2,121	(92)	2,029
Acquisition of subsidiary with non-controlling interests						-	995	995
Decrease in non-controlling interests due to sale of subsidiaries						-	(785)	(785)
Equity as at 31.12.2011	54	10,000	55,000	2,661	55,133	122,794	909	123,703
Translation differences for foreign operations	55			173		173		173
Net income recognised directly in equity		-	-	173	-	173	-	173
Profit for the year					23,438	23,438	(20)	23,418
Total comprehensive income for the year		-	-	173	23,438	23,611	(20)	23,591
Acquisition of subsidiary with non-controlling interests							366	366
Decrease in non-controlling interests due to sale of subsidiaries						-	-	-
Equity as at 31.12.2012	54	10,000	55,000	2,834	78,571	146,405	1,255	147,660

The notes on pages 14 to 87 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2012 10 Amounts are in ISK million

Consolidated Statement of Cash Flows for the year 2012

	Notes	2012	2011
Cash flows from operating activities:			
Profit for the year		23,418	1,866
Adjustments to reconcile profit for the year to cash flows provided by operating activities:			
Non-cash items included in profit for the year and other adjustments		(2,396)	18,573
Changes in operating assets and liabilities		17,896	29,868
Income tax paid		(6,144)	(9,585)
Net cash provided by operating activities		32,774	40,722
Cash flows from investing activities:			
Cash acquired through business combination		-	4,090
Disposal of subsidiary, net of cash sold		-	(3,750)
Acquisition of subsidiary, net of cash acquired		-	4,940
Investments in associated companies		533	-
Proceeds from sale of property and equipment		178	4
Purchase of property and equipment	40	(1,381)	(874)
Purchase of intangible assets	41	(126)	(143)
Net cash (used in) provided by investing activities		(796)	4,267
Cash flows from financing activities:			
Proceeds from borrowings		9,120	3,850
Repayment of borrowings		(6,919)	(7,445)
Net cash provided by (used in) financing activities		2,201	(3,595)
Net increase in cash and cash equivalents		34,179	41,394
Effects of exchange rate changes on cash and cash equivalents		60	25
Cash and cash equivalents at the beginning of the year		78,571	37,152
Cash and cash equivalents at year end		112,810	78,571

Reconciliation of cash and cash equivalents:			
Cash on hand	26	2,008	1,976
Cash balances with Central Bank	26	74,340	49,646
Bank accounts	31	36,462	26,949
Total cash and cash equivalents		112,810	78,571

The Bank 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. Cash and cash equivalents consist of highly liquid assets that are readily convertible into cash and which are subject to an insignificant risk of change in value. These are cash on hand, unrestricted balances with Central Bank and demand deposits with credit institutions.

Interest received in 2012 was ISK 41,470 million (2011: ISK 36,432 million) and interest paid in 2012 was ISK 25,560 million (2011: ISK 18,025 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 14 to 87 are an integral part of these consolidated financial statements

Íslandsbanki hf. Consolidated Financial Statements 2012 11 Amounts are in ISK million

Consolidated Statement of Cash Flows for the year 2012

Non-cash items included in net profit and other adjustments:	2012	2011
Depreciation and amortisation	903	709
Amortisation of intangible assets	425	17,873
Share of loss of associates and subsidiaries	5	389
Indexation and foreign exchange gain on debt issued	2,775	2,437
Impairment of financial assets	19,029	16,468
Income due to revised estimated cash flows from loans	(24,739)	(15,248)
Foreign exchange gain	(3,304)	(944)
Loss on sale of property and equipment	180	14
Unrealised fair value gains through profit and loss	(1,542)	(3,041)
Net profit on non-current assets classified as held for sale	(3,239)	(841)
Bank tax	858	682
Income tax	6,253	75
Non-cash items included in net profit and other adjustments	(2,396)	18,573

Changes in operating assets and liabilities:		
Mandatory reserve with Central Bank	(2,782)	(621)
Loans and receivables to credit institutions	2,955	7,452
Loans and receivables to customers	18,482	37,546
Trading assets	(2,202)	14,808
Other operating assets	1,975	7,159
Non-current assets and liabilities held for sale	5,237	(17,240)
Deposits with credit institutions and Central Bank	(24,892)	(11,272)
Deposits from customers	2,022	(13,959)
Trading financial liabilities	2,645	256
Derivatives	2,629	3,327
Other operating liabilities	11,827	2,412
Changes in operating assets and liabilities	17,896	29,868

Non-cash transactions 2012

During 2012 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Bank recognised fair value changes of ISK 1.5 billion in 2012 which had no cash effect on the Bank.

Non-cash transactions 2011

During 2011 the Bank entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) Deposits from Glitnir were reclassed from deposits to credit institutions to deposits to customers following a reclassification by the FME. The transaction had no cash effect on the Bank.

b) The Bank sold part of its shareholding in an associate held for sale and subsequently lost significant influence over the entity. The remaining equity shares were therefore reclassifed from non-current assets held for sale to financial instruments at fair value through profit and loss and are presented in shares and equity instruments in the statement of financial position. The Bank recognised a fair value gain of ISK 3 billion as part of this transaction. The transaction had no cash effect on the Bank.

c) The consideration for the business combination discussed was in the form of bonds issued in the total amount of ISK 6.6 billion payble in 2014 and 2015. The transaction had no cash effect on the Bank.

The notes on pages 14 to 87 are an integral part of these consolidated financial statements

Íslandsbanki hf. Consolidated Financial Statements 2012 12 Amounts are in ISK million

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. Reporting entity

Íslandsbanki hf. is a limited liability company incorporated and domiciled in Iceland. The address of its registered office is Kirkjusandur 2, 155 Reykjavík, Iceland.

The consolidated financial statements for the year ended 31 December 2012 were prepared on a going concern basis and comprise Íslandsbanki hf. (the parent company) and its subsidiaries (together referred to as "the Bank"). Comparative information refers to the year ended 31 December 2011.

The Bank was incorporated on 8 October 2008 and commenced trading on 15 October 2008 when it acquired assets and liabilities relating to the domestic operations of Glitnir Banki hf. ("Glitnir").

Ownership of Íslandsbanki hf. is divided between ISB Holding ehf., a private limited liability company owned 100% by GLB Holding ehf. which is a private limited liability company owned 100% by Glitnir hf., which wields 95% of the voting rights and the Icelandic State Treasury, which wields 5% of the voting rights. The Icelandic State Treasury's holdings in financial undertakings are managed by The Icelandic State Financial Investments (ISFI - Bankasýsla Ríkisins) which reports to the Minister of Finance.

The Bank provides a wide range of financial services such as retail banking, corporate banking, brokerage services, investment management and asset-based financing. The Bank operates mainly in the Icelandic market, but provides advisory services in relation to seafood and geothermal energy in the United States of America.

2. Basis of preparation

a) *Statement of compliance*

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Information about new IFRS standards and amendments to standards are disclosed in Notes 3.34-3.37.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 27 February 2013.

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue in business for the foreseeable future. Therefore, these consolidated financial statements have been prepared on a going concern basis.

b) *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 and derivative financial assets and liabilities.

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell.

c) *Functional and presentation currency*

These consolidated financial statements are presented in Icelandic krona (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.

d) *Changes in presentation*

The following comparative amounts have been changed due to adjustments between the years:

Comparable information in Notes 32 and 34 has been changed following a change in the categorisation by the FME of certain entities from a credit institution to a customer in 2011. This reduces impairment allowance for loans to credit institutions by ISK 555 million with a corresponding increase in the impairment allowance of investment companies under loans to customers.

Changes have been made in presentation of credit risk notes. These are explained further under Note 61. Comparable information has been changed accordingly.

Comparable information in Note 45 for demand deposits has been changed from ISK 259,994 million to ISK 405,019 million and for time deposits from ISK 202,949 million to ISK 57,924 million in line with the Bank's liquidity management disclosed in Note 69.

Notes to the Consolidated Financial Statements

2.1 Use of significant estimates and judgements in applying accounting policies

The preparation of the consolidated financial statements in conformity with IFRS 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.

The accounting estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates. The accounting estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

The Bank's management discusses with the Audit Committee the development, selection and disclosure of the Bank's critical accounting policies and their application, and assumptions made relating to major estimation uncertainties. Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year and about critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the consolidated financial statements is disclosed below.

a) *Legislative changes and court rulings on foreign currency-linked loans*

Several rulings of the Supreme Court of Iceland during the years 2010 to 2013 have affected the Bank. Most important of these rulings was a ruling in June 2010 on the illegality of a principal of loans in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates. Legislative changes were made as a result of these rulings stipulating that the lowest offered Central Bank rates for non-indexed loans should be applied to the contracts affected by these rulings. Based on the above, the Bank initiated a recalculation of all affected foreign currency-linked loan contracts with the aim of converting them to ISK loan contracts.

A Supreme Court ruling on 15 February 2012 disputed the proposed recalculation methods set out in the legislative changes, as it violated the borrower's constitutional right to an adequate compensation for previously paid up principal. The interpretation of this ruling and how it affected the Bank was uncertain. The Bank therefore made an assessment based on given assumptions and subsequently recognised a provision of ISK 12.1 billion in the consolidated financial statements 2011.

A Supreme Court ruling on 18 October 2012 gave to a certain extent instructions on how the illegal loans should be recalculated and the Bank subsequently recognised an impairment allowance for the illegal loans and made an announcement that it would commence recalculations immediately in line with the instructions given. A provision still remains in place to cover repayments for paid up loans affected by these rulings.

A Supreme Court ruling on 17 January 2013 on an Íslandsbanki currency loan contract further extended the set of loans affected by previous rulings. The Bank recognised an additional provision of ISK 6.5 billion at year end 2012 relating to these rulings.

The Supreme Court rulings in 2012 have gradually reduced the uncertainty regarding the legitimacy of foreign currency linked loans. There remains an uncertainty on whether further Supreme Court rulings will impact on the value of loans. Supreme Court rulings are discussed further under Note 59.

b) *Impairment of loans and receivables measured at amortised cost*

There were uncertainties in input parameters and assumptions used in the valuation of the loans and receivables acquired at a deep discount from Glitnir in 2008 and from Byr in 2011. Valuation estimates were based on the Bank's management's estimates for collateral values and a prudent risk premium, knowledge of the customers and the markets and official macroeconomic forecasts.

Factors that can affect the recovery value of the loans and receivables include macroeconomic parameters such as the unemployment rate, inflation and wage growth, as well as actions taken by the government to facilitate and ease debt service and legislation that lengthens the collection process or increases taxation and the extent of customer participation in flexible maturity and payment equalisation programmes.

At 31 December 2012 many of the uncertainties surrounding the initial valuation of the loans and receivables acquired at a deep discount and the economic environment were still present. The Bank's management is, however, confident that the Bank's capital base is robust enough to absorb reasonable variances in applied assumptions.

The Bank's management reviews its loan portfolios on a quarterly basis to assess whether there is any objective evidence of impairment. In determining whether an impairment loss should be recognised in the income statement, the Bank's management makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from loans and receivables. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the Bank.

Notes to the Consolidated Financial Statements

2.1 **Cont'd**

When scheduling its future cash flows the Bank's management uses estimates based on loans and receivables with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. Impairment of loans and receivables is disclosed in more detail in Note 3.23.

c) *Impairment of foreign exchange gains for loans acquired at a deep discount*

The loan portfolio contains loans in foreign currencies to customers with revenue and cash flows in ISK. The foreign exchange gain or loss on these loans is recognised in profit or loss as net financial income (expenses). However, as the Bank does not expect to recover foreign exchange gain relating to these loans, the foreign exchange gain is recognised immediately in full as an impairment loss in profit or loss in the line item net valuation changes. If, in a subsequent period, the Bank incurs a foreign exchange loss, previous impairment loss of foreign exchange gain is reversed.

d) *Determination of fair value of financial assets and financial liabilities*

The Bank determines the fair value of financial assets and financial liabilities that are not quoted in active markets by using valuation techniques as described in accounting policy Note 3.5. To the extent that it is practical, models use only observable data. However, for financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument, such as credit risk (both own and counterparty).

e) *The application of the effective interest method*

The application of the effective interest method when calculating the amortised cost of financial assets and financial liabilities requires management to estimate future cash payments or receipts through the expected life of the financial instrument, considering all contractual terms of the financial instrument (for example, prepayment, call and similar options). Revisions to estimates of future cash flows, other than those arising from changes in market variables, generally result in the Bank having to adjust the carrying amount of the financial asset or financial liability to reflect actual and revised estimated cash flows. In such cases the adjustment is recognised as income or expense in profit or loss in the period in which the estimate is revised.

f) *Restructuring and forbearance*

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

The Bank has offered several debt relief measures and restructuring frameworks for its customers since its establishment. These restructuring frameworks include principal adjustment and recalculation of currency linked loans, debt adjustment of SME companies, 110% adjustment of mortgages, interest discount, specific debt adjustment, write-offs and tailor made solutions in complicated cases where general solutions do not suffice. In some cases, often prior to formal restructuring, customers undergo less formal forbearance measures such as temporary payment holidays, extension of loans terms and capitalisation of arrears.

This has been done without a significant loss to the Bank because the loan portfolio was acquired at a deep discount. The Bank has furthermore offset any foreign exchange gain or loss due to currency movements relating to loans to customers with ISK cash flow. More details on the accounting policies regarding impairment on loans can be seen in Note 3.23.

Further details on forbearance and the restructuring of customers can be seen in the Íslandsbanki's Risk Report which is published concurrent to the annual report.

g) *Liquidity*

The Bank manages its liquidity by maintaining an adequate portfolio of liquid assets against liabilities. Internal liquidity limits assume that liquid assets cover all liabilities expected to mature within the next 12 month period, even under stressed market conditions.

The expected maturity profile of the Bank's liabilities is based on analysis of the historical behaviour and other characteristics of the deposit base. The contractual maturity profile is set out in the liquidity risk disclosure in Note 69. The table requires judgement with respect to whether assets can be considered liquid and when deposits will be withdrawn.

h) *Reimbursement of interest*

During 2012, the Bank decided to reward individuals which have kept up with their payment terms on mortgages and other term loans by reimbursing interest payments of ISK 2,493 million. The reimbursement took place on 25 February 2013 and the amount is reflected in these consolidated financial statements. A part of the reimbursement falls under the definition of an impairment event according to IAS 39 as it relates to the restructuring process. The Bank has therefore recognised a charge in profit or loss of ISK 2,141 million in the line item "Net valuation changes on loans and receivables". The remaining amount of ISK 352 million is recognised as a discount and is charged to profit or loss in the line item "Interest income".

Notes to the Consolidated Financial Statements

3. Significant accounting policies

The accounting policies set out below have been applied consistently by all Bank entities to all periods presented in these consolidated financial statements.

3.1 Basis of consolidation

a) *Subsidiaries*

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds 50% or more of the voting power of the subsidiaries. In assessing control, the Bank takes into consideration any potential voting rights that are currently exercisable or convertible.

In preparing the consolidated financial statements, the parent company combines its financial statements with those of its subsidiaries, line by line by adding together like items of assets, liabilities, equity, income and expenses, and applies the required consolidation procedures. Intra-group balances and transactions, and any unrealised income and expenses arising from intra-bank transactions, are eliminated, except for foreign currency transaction gains or losses. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment. If a Bank entity uses accounting policies other than those adopted in the consolidated financial statements for like transactions and events in similar circumstances, the Bank makes appropriate adjustments to that entity's financial statements when preparing the consolidated financial statements. The financial statements of subsidiaries are included in the consolidated financial statements of the Bank from the date that control commences until the date that control ceases.

Subsidiaries which the Bank acquires exclusively with a view to resale, often through restructuring or repossession following a customer default, when the Bank expects that their carrying amount to be recovered principally through a sale transaction are classified as Non-current assets and disposal groups held for sale and measured according to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations (see Note 3.14).

Subsidiaries are consolidated even if they are held exclusively with a view to subsequent disposal and classified as held-for-sale. Consolidation requires the application of acquisition accounting (see Note 3.1b).

b) *Business combinations*

Acquisitions of subsidiaries and other businesses are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Bank.

The following steps are applied for the acquisition method:
1. Identification of the 'acquirer' – the combining entity that obtains control of the acquiree;
2. Determination of the 'acquisition date' – the date on which the Bank obtains control of the acquiree;
3. Recognition and measurement of the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree;
4. Recognition and measurement of goodwill or a gain from a bargain purchase.

The Bank measures goodwill at the acquisition date as:
• the fair value of the consideration transferred; plus
• the recognised amount of any non-controlling interests in the acquiree; plus
• if the business combination is achieved in stages, the fair value of the Bank's previously held equity interest in the acquiree, less
• the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed.
When the excess is negative, a bargain purchase gain is recognised immediately in profit or loss.

The consideration transferred by the Bank is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the assets transferred by the Bank, the liabilities incurred by the Bank to former owners of the acquiree and the equity interests issued by the Bank, if any. The consideration transferred does not include amounts related to the settlement of pre-existing relationships. Such amounts are generally recognised in profit or loss. Where applicable, the consideration transferred includes any asset or liability resulting from a contingent consideration arrangement, measured at its acquisition date fair value. Subsequent changes in the fair value of contingent consideration classified as an asset or liability are accounted for in accordance with relevant IFRSs. Changes in the fair value of contingent consideration classified as equity are not recognised.

Where a business combination is achieved in stages, the Bank's previously held interests in the acquiree are remeasured to fair value at the acquisition date and the resulting gain or loss, if any, is recognised in profit or loss. Amounts arising from interests in the acquiree prior to the acquisition date that have previously been recognised in other comprehensive income are reclassified to profit or loss, where such treatment would be appropriate if that interest were disposed of.

Notes to the Consolidated Financial Statements

3.1 **Cont'd**

The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 are recognised at their fair value at the acquisition date, except that:
• Deferred tax assets and liabilities are recognised and measured in accordance with IAS 12 Income Taxes;
• Assets and liabilities related to employee benefit arrangements are recognised and measured in accordance with IAS 19 Employee Benefits;
• Liabilities or equity instruments related to the replacement by the Bank of an acquiree's share-based payment awards are measured in accordance with IFRS 2 Share-based Payment;
• Assets (or disposal groups) that are classified as held for sale at the acquisition date in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations are measured in accordance with that standard.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Bank reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period, or additional assets or liabilities are recognised, to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the amounts recognised as of that date. The measurement period is the period from the date of acquisition to the date the Bank obtains complete information about facts and circumstances that existed as at the acquisition date, subject to a maximum of one year.

Transaction costs, other than those associated with the issue of debt or equity securities, that the Bank incurs in connection with a business combination are expensed as incurred.

c) *Non-controlling interests*

Non-controlling interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Bank. Non-controlling interests are presented separately in the income statement and within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of the Bank.

Non-controlling interests in the net assets consist of the amount of those non-controlling interests at the date of the original combination and the non-controlling interests' share of changes in equity since the date of the combination.

For each business combination, the Bank 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.

Changes in the Bank's interest in a subsidiary that do not result in loss of control are accounted for as transactions with owners in their capacity as owners. Adjustments to non-controlling interests are based on a proportionate amount of the net assets of the subsidiary. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

d) *Loss of control*

When the Bank is committed to a sale plan involving the loss of control of a subsidiary it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements when the criteria for classification as held for sale are met (see Note 3.14). This is regardless of whether the Bank will retain a non-controlling interest in the subsidiary after the sale.

On the loss of control, the Bank derecognises the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item “Net financial income (expenses)”. If the Bank retains any interest in the previous subsidiary, then such interest is measured at fair value at the date that control is lost. Subsequently, that retained interest is accounted for as an equity-accounted investee or in accordance with the Bank´s accounting policy for financial instruments, depending on the level of influence retained.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 3.30), the Bank presents the gain or loss from disposal in the income statement in the line item “Profit (loss) from discontinued operations, net of income tax”.

e) *Funds management*

The Bank manages and administers assets held in unit trusts on behalf of investors. The financial statements of these entities are not included in these consolidated financial statements, except when the Bank controls the entity.

Notes to the Consolidated Financial Statements

3.2 Foreign currencies

a) *Foreign currency transactions*

Items included in the financial statements of each of the Bank'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 3.26).

b) *Foreign operations*

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into the presentation currency, Icelandic krona (ISK), at spot exchange rates at the reporting date. The income and expenses of foreign operations are translated into ISK at rates approximating the spot exchange rates at the dates of the transactions.

Foreign currency differences arising on translation are recognised in other comprehensive income and accumulated directly in the translation reserve in equity. However, if the foreign operation is a non-wholly owned subsidiary, the relevant proportion of the translation difference is allocated to non-controlling interest. When a foreign operation is disposed of in such a way that control is lost, the cumulative amount in the translation reserve related to that foreign operation is reclassified from equity to profit or loss as part of the gain or loss on sale. When the Bank disposes of only part of its interest in a subsidiary that includes a foreign operation while retaining control, the relevant proportion of the cumulative amount is reattributed to non-controlling interests.

3.3 Financial assets

For the purpose of measuring its financial assets, the Bank classifies them at inception in one of the following categories (see also Note 7):

- Loans and receivables; or
- Financial assets at fair value through profit or loss, either as:
  - held for trading; or
  - designated as at fair value through profit or loss.

a) *Loans and receivables*

Loans and receivables are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term, other than those that the Bank designates upon initial recognition as financial assets at fair value through profit or loss. Loans and receivables include loans originated by the Bank to its customers and credit institutions, acquired loans, participations in loans from other lenders and finance lease receivables (see Note 3.10 (b)).

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date (reverse repurchase transactions), the arrangement is accounted for as a loan or receivable, and the underlying asset is not recognised in the consolidated financial statements of the Bank.

Loans and receivables are recognised when cash is advanced to borrowers. On initial recognition they are measured at fair value plus incremental direct transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the loans and receivables 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 (see Note 3.23). Accrued interest is included in the carrying amount of the loans and receivables in the statement of financial position.

Notes to the Consolidated Financial Statements

3.3 Cont'd

Gains and losses on loans and receivables are recognised in profit or loss in the line item “Interest income” when the loans and receivables are derecognised and in the line item “Net foreign exchange gain (loss)” when the loans and receivables are re-measured for foreign exchange differences. The losses arising from impairment are recognised in profit or loss in the line item “Net valuation changes on loans and receivables”, except for impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK, which are recognised in profit or loss in the line item “Net foreign exchange gain (loss)” (see Notes 2.1(c), 3.22 and 3.26).

A large proportion of the Bank's current loans and receivables were acquired at a deep discount. Credit losses already incurred were reflected in the purchase price and included in the estimated future cash flows when computing the effective interest rates of the loans and receivables. A loan and receivable is defined as having been acquired at a deep discount when the fair value on acquisition is considerably lower than the balance according to the terms of the loan. The difference is explained by severe financial difficulties of the debtor which manifests itself in a higher credit spread when estimating the fair value of the loan and not because of changes in business environment since the terms of the loan were agreed, i.e. market interest rates.

Discounts arising at the initial recognition of the acquired loans and receivables and resulting from the difference between market interest rates and nominal interest rates of the loans and receivables are amortised over the expected life of the financial asset. However, a shorter period is used if this is the period to which the discounts relate.

b) *Financial assets designated at fair value through profit or loss*

The Bank designates certain financial assets upon their initial recognition as financial assets at fair value through profit or loss when doing so results in more relevant information because:
- It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses from them on different bases; or
- Financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank's risk management or investment strategy, and information about it is provided internally on that basis to the Bank's key management personnel; or
- The financial assets and/or financial liabilities contain an embedded derivative that significantly modifies the cash flows that would otherwise have been required under the contract.

Assets classified according to the above-mentioned conditions consist of:
- Fixed interest rate loans originated by the Bank whose fixed interest has been swapped into floating by entering into corresponding interest rate swaps;
- Debt and equity instruments, which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial assets designated by the Bank as at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest earned, which is recognised in the line item "Interest income" on an accrual basis.

c) *Financial assets held for trading*

Financial assets held for trading are financial assets acquired principally for the purpose of selling or repurchasing in the near term, or for holding as part of a portfolio that is managed together for short-term profit or position taking. Financial assets held for trading consist of bonds and debt instruments, shares and equity instruments, and derivatives with positive fair value which are not designated as hedging instruments.

Financial assets held for trading are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest earned, which is recognised in the line item "Interest income" on an accrual basis.

3.4 Financial liabilities

Except for financial guarantees (see Note 3.15) and loan commitments (see Note 3.16), for the purpose of measuring its financial liabilities, the Bank classifies them in one of the following categories (see also Note 7):
- Financial liabilities held for trading; or

- Financial liabilities measured at amortised cost.

The Bank does not designate financial liabilities as at fair value through profit or loss.

3.4 Cont'd

a) *Financial liabilities held for trading*

Financial liabilities held for trading are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities held for trading 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 held for trading are initially recognised and subsequently measured at fair value in the statement of financial position with transaction costs taken directly to profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expenses)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis.

b) *Financial liabilities measured at amortised cost*

Financial liabilities measured at amortised cost are non-derivative financial liabilities which are not classified by the Bank as financial liabilities held for trading. 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.

3.5 Determination of fair value of financial assets and financial liabilities

A number of the Bank's accounting policies and disclosures require the determination of fair value for measurement and/or disclosure purposes. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction at the measurement date.

When available, the Bank measures the fair value of an instrument 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 market transactions on an arm's length basis.

If a market for a financial instrument is not active, the Bank establishes its fair value using a valuation technique. Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, discounted cash flow analyses and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Bank entity and the counterparty where appropriate. Periodically, the Bank calibrates the valuation techniques and tests them for validity using prices from observable current market transactions in the same instrument, without modification or repackaging, or based on other available observable market data.

For more complex financial instruments, the Bank uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, in which case the inputs are derived from market prices or rates or estimated based on assumptions. The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors, to the extent that the Bank believes a third-party market participant would take them into account in pricing a transaction. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the statement of financial position.

All long and short positions are measured at the latest closing price as obtained from the relevant securities market. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Bank recognises the difference between the transaction price and fair value in profit or loss in the line item "Net financial income (expenses)" on initial recognition of the financial instrument. In cases where use is made of data which is not from observable markets, the difference between the transaction price and the value produced by the valuation technique, if any, is recognised in profit or loss in the line item "Net financial income (expenses)", depending upon individual facts and circumstances of each transaction and not later than when the data becomes observable or when the instrument is redeemed, transferred or sold.

3.6 Recognition and derecognition of financial assets and financial liabilities

The Bank uses trade date accounting to recognise purchases and sales of financial assets, i.e. they are recognised on the date on which the Bank commits to purchase or sell the asset, except for loans, which are recognised on the date when cash is advanced by the Bank to the borrowers. For a financial asset purchased, the Bank recognises on the trade date a financial asset to be received and a financial liability to pay. For a financial asset sold, the Bank derecognises the asset on the trade date, recognises any gains or losses on disposal and recognises a receivable from the buyer.

The Bank recognises financial liabilities held for trading on the trade date, i.e. on the date at which the Bank becomes a party to the contractual provisions of the financial instrument. The Bank recognises financial liabilities measured at amortised cost on the date when they originated. The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

The Bank derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Bank transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Bank transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Bank 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 Bank 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 Bank 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 Bank. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Bank does not derecognise from its statement of financial position securities which the Bank 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 Bank 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 Bank neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Bank 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.

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Bank derecognising the original financial assets and recognising new financial assets at fair value. See also Note 3.23(a) with respect to renegotiated loans.

3.7 Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount presented in theconsolidated statement of financial position when, and only when, the Bank 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.

3.8 Derivative financial instruments

Derivatives entered into by the Bank may be in the form of stand-alone contracts or embedded in other contracts, in which case the Bank assesses whether it is required to separate and account for the embedded derivatives as if they were stand-alone contracts. That would be the case when the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host contracts; stand-alone contracts with the same terms as the embedded derivatives would meet the definition of a derivative for accounting purposes; and the combined contracts are not classified by the Bank as financial assets or financial liabilities held for trading or designated by the Bank as at fair value through profit or loss.

3.8 Cont'd

Derivatives which do not classify as equity instruments of the Bank 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 the Bank is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Bank presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Bank presents the related host contracts.

The Bank did not apply hedge accounting during the year ended 31 December 2012, nor during the comparative period. Accordingly, the Bank accounted for all its derivative financial assets and liabilities as financial assets or financial liabilities held for trading in accordance with Notes 3.3(b) and 3.4(a).

3.9 Investments in associates

Associates are those entities over which the Bank has significant influence, which is the power to participate in the financial and operating policy decisions of the entity but is not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights that are currently exercisable or convertible, if any.

Investments in associates are accounted for using the equity method and are initially recognised at cost. The investments include goodwill identified on acquisition. The carrying amount of the investments is adjusted for post-acquisition changes in the Bank's share of net assets of the associates and for impairment losses, if any (see Note 3.23(b)). Therefore, the consolidated financial statements include the Bank's share of the total recognised gains and losses of associates, from the date that significant influence commences until the date that significant influence ceases. When the Bank's share of losses 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 Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Bank resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

Investments in associates which are classified as held for sale are not accounted for using the equity method but in accordance with the accounting policy disclosed in Note 3.14.

3.10 Leases

The Bank 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.

a) *Bank as a lessee*

Lease payments under operating leases where the Bank is the lessee are recognised as an expense on a straight-line basis over the lease term.

b) *Bank as a lessor*

When the Bank is the lessor in a finance lease, the Bank recognises a finance lease 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 Bank applies its accounting policies for derecognition and impairment of loans and receivables also to its finance lease receivables. The Bank recognises the finance income from finance lease receivables in profit or loss in the line item “Interest revenue” over the period of the lease so as to give a constant periodic rate of return on the net investment in the lease.

When the Bank is lessor in arrangements which involve the legal form of leases, but which in substance do not involve leases, the Bank does not apply lease accounting to those arrangements and instead the Bank accounts for them as loans and receivables.

3.11 Investment property

When the Bank holds certain properties, i.e. land or a building or part of a building or both, to earn rental income or for capital appreciation or both, the property is classified as an investment property and is measured initially at cost, including transaction costs. Subsequently, investment property is measured at fair value, which reflects market conditions at the reporting date. Changes in the fair values are included in the income statement in the line item "Other net operating income". The Bank did not hold any investment properties during the year ended 31 December 2012, nor during the comparative period.

Properties that are leased to its parent or another subsidiary do not qualify as investment property in consolidated financial statements, because the property is owner-occupied from the perspective of the Bank although from the perspective of the entity that owns it, the property is treated as an investment property in the lessor’s individual financial statements.

Notes to the Consolidated Financial Statements

3.11 Cont'd

When the Bank takes possession of a property that was originally pledged as security in full and final settlement of a mortgage loan, the property is classified based on its intended use. When the property is acquired exclusively with a view to subsequent disposal in the near future it is measured at the lower of cost or net realisable value.

3.12 Property and equipment

a) *Recognition and measurement*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses.

Where parts of an item of property and equipment have different useful lives, those components are accounted for as separate items of property and equipment.

b) *Subsequent costs*

The Bank 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 Bank and the cost of the item can be measured reliably. The decision if subsequent costs are added to the acquisition cost of the property or equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are recognised in profit or loss as incurred.

c) *Depreciation*

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. Each part of a depreciable item of property and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The depreciable amount of each significant 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 for the current and comparative periods of significant items of property and equipment are as follows:

Buildings	50 years
Fixtures	6 - 12 years
Equipment	4 years
Vehicles	3 years

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

3.13 Intangible assets

a) *Goodwill*

The Bank recognises goodwill as an asset only when it results from a business combination. Goodwill relating to acquisition of associates is not recognised separately as an asset but it is included in the carrying amount of investments in associates in the statement of financial position. For the measurement of goodwill at initial recognition, see Note 3.1(b).

Goodwill is allocated from the acquisition date to cash-generating units (CGUs) and it is subsequently measured at cost less accumulated impairment losses. Goodwill is tested by the Bank for impairment annually or whenever there is an indication that the CGUs may be impaired.

b) *Software*

Software acquired by the Bank is measured at cost less accumulated amortisation and impairment losses.
Expenditure on internally developed software is recognised as an asset when the Bank 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 for the current and comparative periods is four years.

3.14 Non-current assets and disposal groups held for sale

Non-current assets and disposal groups (comprising groups of assets and liabilities associated with those assets, including non-current assets) are classified as held for sale and presented in separate line items on the face of the statement of financial position if the Bank 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 classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable IFRSs. 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 Bank 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 Bank applicable to those liabilities.

Non-current assets and the assets and liabilities of a disposal group classified as held-for-sale are presented separately from other assets and liabilities in the statement of financial position. Non-controlling interests in a disposal group classified as held-for-sale are presented within equity consistent with the requirements of IAS27 and are not reclassified as a liability.

Any impairment loss on a disposal group is allocated first to any goodwill included in the disposal group, and then to the remaining assets and liabilities on a pro rata basis, except for that no loss is allocated to inventories, financial assets, deferred tax assets and investment property.

Impairment losses on initial classification of non-current assets and disposal groups as held for sale and subsequent gains and losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

Income earned and expenses incurred on assets and disposal groups held for sale continue to be recognised in the appropriate line items in profit or loss until the transaction is complete. However, income and expenses on assets and liabilities of subsidiaries acquired by the Bank exclusively with a view to resale are recognised in profit or loss in the line item “Profit (loss) from discontinued operations, net of income tax” (see Note 3.30).

3.15 Financial guarantees

Financial guarantees are contracts that require the Bank 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 Bank 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 Bank are initially measured at their fair value, being the premium received, and the initial fair value is amortised on a straight line basis over the life of the guarantee. The liabilities are subsequently carried at the higher of the unamortised premium and the best estimate of the expenditure required to settle the liability when a payment under the contracts has become probable. The estimates are determined based on experience of similar transactions and history of past losses, supplemented by a judgement by the management.

Any increase in the liabilities arising from financial guarantees is recognised in profit or loss. The premium received is recognised as revenue in profit or loss in the line item "Fee and commission income".

3.16 Loan commitments

Loan commitments are firm commitments of the Bank to provide credit under pre-specified terms and conditions. All loan commitments issued by the Bank are outside the scope of IAS 39. As such, the Bank recognises a provision for loan commitments in the statement of financial position, in the line item “Other liabilities”, only when the Bank is committed to making a loan that would be considered to be impaired or when the commitment becomes onerous. The related expense is then recognised in profit or loss. Loan commitment fees received by the Bank are recognised in accordance with the accounting policy disclosed in Note 3.24.

3.17 Provisions

Provisions are recognised when the Bank has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Bank 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 balance sheet 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 Bank 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.

3.18 Employee benefits

All Bank entities are required to pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Bank has no further payment obligations once these contributions have been paid by the Bank. The Bank recognises these contributions as salary related expenses when they become due. The Bank does not have a defined benefit pension plan.

Termination benefits are recognised by the Bank as a salary expense when the Bank is demonstrably committed, without realistic possibility of withdrawal, to a formal detailed plan to either terminate employment before the normal retirement date, or to provide termination benefits as a result of an offer made to encourage voluntary redundancy. Termination benefits for voluntary redundancies are recognised as an expense if the Bank has made an offer of voluntary redundancy, it is probable that the offer will be accepted, and the number of acceptances can be estimated reliably.

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 Bank 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 Bank 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.

3.19 Share capital

a) *Share capital*
The share capital disclosed in the consolidated financial statement represents the total nominal value of ordinary shares issued by the parent company and outstanding at the reporting date. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

b) *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 in 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.

3.20 Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash on hand, treasury bills, demand deposits with the Central Bank and with other credit institutions, short-term loans to credit institutions and other liquid debt securities at floating interest rates. 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 Bank in the management of its short-term cash commitments.

3.21 Interest income and expense

For all financial assets and financial liabilities measured at amortised cost interest income and expense is recognised in profit or loss using the effective interest method. For all financial assets and financial liabilities held for trading and for all financial assets designated at fair value through profit or loss, interest income and expense is recognised through profit or loss on an accrual basis.

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 Bank 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 Bank 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 expense. For floating rate instruments, interest income or 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 to the carrying amount as reduced by any allowance for impairment.

Interest income and expense include gains and losses on derecognition of loans and receivables and financial liabilities measured at amortised cost.

3.22 Net valuation changes on loans and receivables

Net valuation changes on loans and receivables is the net amount recognised in profit or loss following a revision of estimates of receipts from loans and receivables. It is made up of income due to revision of estimated future cash flows and expenses due to individually and collectively assessed impairment losses on loans and receivables (see Note 3.23), but excludes impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK (see Notes 2.1(c) and 3.26).

a) *Revised estimated future cash flows*

At each reporting date, the Bank assesses the current status of loans and advances and whether there is any objective evidence of changes in expected cash flows, for example due to differences in estimated and actual payments, changes in the value of collaterals and improvement in the financial situation of debtors. If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised or acquired, the previously recognised impairment loss is reversed. The amount of any reversal is recognised in profit or loss in the line item “Net valuation changes on loans and receivables”.

The Bank acquired part of the loans and advances at a deep discount that reflects incurred credit losses. The Bank includes such incurred credit losses in the estimated cash flows when computing the effective interest rate. If the Bank revises its estimate of payments or receipts, the Bank adjusts the carrying amount of the loans and advances, to reflect actual and revised estimated cash flows. If there is any change in expected cash flows, the Bank recalculates the carrying amount of these loans and advances as the present value of the revised estimated future cash flows, using their effective interest rate method. The difference between the revised carrying amount of the loans and their current carrying amount, which includes accrued interest, indexation, foreign exchange differences and actual payments received by the Bank, is recognised in profit or loss in the line item “Net valuation changes on loans and receivables”.

The Bank recognises interest and indexation on these loans and advances based on their carrying amount and only to the extent that the interest and indexation are deemed to be collectible. The interest and indexation are recognised in profit or loss in the line item "Interest income".

b) *Provision for latent impairment*

Provision for latent impairment losses reflects estimates of impairment losses that have been incurred but not identified in the reporting period.

3.23 Impairment

The carrying amounts of the Bank's assets, other than tax assets and financial assets measured at fair value with changes recognised through profit or loss, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised in profit or loss whenever the carrying amount of a tangible or intangible asset or of a cash-generating unit exceeds its recoverable amount.

Notes to the Consolidated Financial Statements

3.23 Cont'd

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

a) *Impairment of loans and receivables*

If there is objective evidence that an impairment loss has been incurred on loans and receivables, their carrying amount is reduced through the use of an allowance account to the present value of expected future cash flows, discounted at their original effective interest rate.

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:
- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (for example, equity ratio, net income, percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the customer's competitive position;
- Deterioration in the value of collateral;
- Downgrading of an asset;
- Restructuring and forbearance.

The Bank's management first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Loans and receivables that are not impaired individually become a part of a portfolio which is assessed for impairment. Collective assessment based on a portfolio assumes that loans and receivables have similar credit risk characteristics. Objective evidence of impairment of a group of loans and receivables exists if objective data indicates a decrease in expected future cash flows from a portfolio of loans and the decrease can be measured reliably but cannot be identified with the individual loans in the portfolio.

Interest income on impaired loans and receivables is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring impairment losses.

Calculation of recoverable amount

The recoverable amount of the Bank's loans and receivables is calculated as the present value of estimated future cash flows. The discount rate used for fixed rate loans and receivables is the effective interest rate computed at initial recognition. For variable rate loans and receivables the discount rate is the current effective interest rate.

The recoverable amount of other assets or cash generating units (CGUs) is the greater of their value in use and fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset or CGU. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the CGU to which the asset belongs.

Loan write-offs:

When a loan is uncollectible, it is written-off against the related allowance for impairment. Such loans are written-off after all the necessary procedures have been completed and the amount of the loss has been determined.

Reversals of impairment

An impairment loss in respect of loans and receivables is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

When loans and receivables are acquired at a deep discount, credit losses have already occurred and are reflected in the purchase price. Such incurred credit losses are included in the estimated cash flows when computing the effective interest rate. Any adjustments arising from revisions to estimated cash flows subsequent to initial recognition are recognised as part of the carrying amount of the loans and receivables with a corresponding amount recognised in profit or loss under the line item “Net valuation changes from loans and receivables”. Upwards changes in estimated future cash flows are first recognised as a reversal of previously recognised impairment losses. The remaining balance is recognised in profit or loss as income from revised estimated future cash flows from loans. Downwards revisions to estimated future cash flows are recognised in profit or loss.

An impairment loss in respect of goodwill is never reversed.

3.23 Cont'd

In respect of other assets, an impairment loss 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.

Renegotiated loans

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment.

If the terms of a financial asset are renegotiated or modified or an existing financial asset is replaced with a new one due to financial difficulties of the customer then an assessment is made whether the financial asset should be derecognised. If the cash flows of the renegotiated asset are substantially different, then the contractual rights to the cash flows from the original financial asset are deemed to have expired. In this case the original financial asset is derecognised and the new financial asset is recognised at fair value. The impairment loss is measured as follows:

• If the expected restructuring does not result in derecognition of the existing asset, the estimated cash flows arising from the modified financial asset are included in the measurement of the existing asset based on their expected timing and amounts discounted at the original effective interest rate of the existing financial asset.

• If the expected restructuring results in derecognition of the existing asset, then the expected fair value of the new asset is treated as the final cash flow from the existing financial asset at the time of derecognition. This amount is discounted from the expected date of derecognition to the reporting date using the original effective interest rate of the existing financial asset.

b) *Impairment of associates*

Whenever there is an objective evidence that an investment in associates may be impaired, the entire carrying amount of the investment is tested for impairment by comparing its recoverable amount with its carrying amount, goodwill included in the carrying amount of an investment in an associate is not recognised separately and is therefore not tested separately for impairment according to the requirements for impairment testing of goodwill

c) *Impairment of non-financial assets*

The carrying amounts of the Bank's non-financial assets, other than investment property and 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. For goodwill and intangible assets that have indefinite useful lives or that are not yet available for use, the recoverable amount is estimated each year at the same time. An impairment loss is recognised if the carrying amount of an asset or cash-generating unit (CGU) exceeds its estimated recoverable amount. Impairment losses on goodwill are recognised in profit or loss under the line item “Impairment of goodwill”.

3.24 Net fee and commission income

Net fee and commission income comprises fees and commission income and expenses. Fees and commissions are generally recognised on an accrual basis when the service has been provided.

Fees and commission income and expense that are integral to the effective interest rate on a financial asset or 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.

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Bank 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.

Notes to the Consolidated Financial Statements

3.24 Cont'd

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.

3.25 Net financial income (expenses)

Net financial income (expenses) consist of net gains on financial assets and liabilities held for trading, net gain on financial assets designated at fair value through profit or loss and net gain on loss of control over subsidiaries.

a) *Net gain (loss) on financial assets and liabilities held for trading*

Net gain (loss) on financial assets and liabilities held for trading includes all realised and unrealised fair value changes of financial assets and liabilities classified by the Bank as held for trading, except for interest income and interest expense (which are included in the line items “Interest income” and “Interest expense”, see Note 3.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, see Note 3.26). Dividend income from financial assets held for trading is recognised in profit or loss when the Bank's right to receive payment is established.

Changes in fair value of derivatives that are classified as held for trading but which are economic hedges of financial assets designated at fair value through profit or loss are presented in the notes to the consolidated financial statements as an offset to net gains on financial assets designated at fair value through profit or loss (see Note 15).

b) *Net gain (loss) on financial assets designated at fair value through profit or loss*

Net gain (loss) on financial assets designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets designated by the Bank as 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”, see Note 3.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, see Note 3.26). Dividend income from financial assets designated at fair value through profit or loss is recognised in profit or loss when the Bank's right to receive payment is established.

Net gain on financial assets designated at fair value through profit or loss also include changes in fair value of derivatives that are classified by the Bank as held for trading but which are economic hedges of financial assets designated by the Bank as at fair value through profit or loss.

3.26 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 period 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 Bank at fair value in foreign currencies and whose other gains and losses are also recognised in profit or loss.

On the face of the income statement, net foreign exchange gain (loss) is offset by impairment losses and reversal of impairment losses due to foreign exchange gain on loans in foreign currencies to customers with revenue and cash flows in ISK, as the Bank does not expect to recover the foreign exchange gain on these loans.

3.27 Income tax

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations, excluding the Bank's share of income tax of the Bank's equity-accounted associates. 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 3.30).

3.27 Cont'd

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 Bank 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 and tax liabilities are presented separately from other assets and liabilities in the statement of financial position, whereby current tax liabilities are distinguished from deferred tax assets and deferred tax liabilities. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 3.14) 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 Bank 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 Bank 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.

3.28 Bank tax

Bank tax is a tax on credit institutions whose 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 tax is calculated as 0.041% of total liabilities. The Bank tax is shown in a separate line on the face of the income statement.

Also recognised under bank tax is a temporary tax on credit institutions to finance tax credits on mortgage interest payable to borrowers. The tax is applicable for the tax years ended 31 December 2011 and 31 December 2012, but is payable one year in advance. The tax is calculated as 0.0875% of total liabilities.

3.29 Administrative expenses

Administrative expenses consist of salaries and related expenses, depreciation of property and equipment, amortisation of intangible assets and other administrative expenses, such as housing costs, advertising expenses and IT-related expenses.

3.30 Discontinued operations

The Bank presents in a separate line in the income statement the profit or loss from discontinued operations, net of income tax. Discontinued operations consist of subsidiaries acquired by the Bank exclusively with a view to resale that meet the criteria to be classified as held for sale (see Note 3.14) from acquisition date.

The profit or loss from discontinued operations consists of (a) the post-tax profit or loss of the subsidiaries acquired by the Bank exclusively with a view to resale, (b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell and on the disposal of the subsidiaries acquired by the Bank exclusively with a view to resale and (c) the post-tax profit or loss from the sale of foreclosed assets held for sale.

Notes to the Consolidated Financial Statements

3.31 Offsetting income and expenses

The Bank presents income and expenses on a net basis in the income statement only when required or permitted under IFRSs.

3.32 Earnings per share

The Bank 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 Bank 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.

3.33 Segment reporting

A business segment is a component of the Bank 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 Bank's other components. Each business segment is engaged in providing products or services which are subject to risk and return that are different from those of other business segments, and which are subject to regular review by the Bank's Board of Directors and Chief Executive Officer for the purpose of allocating resources and assessing performance.

3.34 Initial application of new standards and amendments to standards which had an effect on the consolidated financial statements of the Bank

The initial application of the following new standards and amendments to standards which became effective for the Bank on 1 January 2012 affected the consolidated financial statements of the Bank as follows:

Amendments to IFRS 7 Financial Instruments: Disclosures – Transfers of Financial Assets, which require the Bank to disclose information that enables the users of the consolidated financial statements of the Bank (i) to understand the relationship between transferred financial assets which the Bank did not derecognise in their entirety and the associated liabilities; and (ii) to evaluate the nature of, and risks associated with, the Bank's continuing involvement in derecognised financial assets.

3.35 New standards and amendments to standards which became effective for the Bank on 1 January 2012 but had no effect on the consolidated financial statements of the Bank

The following new standards and amendments to standards which became effective on or after 1 January 2012 had no effect on the consolidated financial statements of the Bank:

a) Amendments to IFRS 7 Financial Instruments: Disclosures – Transfers of Financial Assets;

b) Amendments to IAS 12 Income Taxes – Deferred Tax: Recovery of Underlying Assets.

3.36 New standards and amendments to standards adopted in advance by the Bank

The Bank did not early adopt any standards or amendments to standards which become effective after 1 January 2012.

3.37 New standards and amendments to standards which become effective for the Bank for annual periods beginning on or after 1 January 2013 and which have not been adopted in advance by the Bank

The following new standards and amendments to standards become effective for annual periods beginning on or after 1 January 2013 and have not been early adopted by the Bank. From those new standards and amendments only the following are expected to have a material effect on the consolidated financial statements of the Bank:

a) Amendments to IAS 1 – Presentation of Items of Other Comprehensive Income, which require additional disclosures to be made in the other comprehensive income section such that items of other comprehensive income are grouped into two categories: (a) items that will not be reclassified subsequently to profit or loss; and (b) items that will be reclassified subsequently to profit or loss when specific conditions are met. Income tax on items of other comprehensive income is required to be allocated on the same basis. These amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required. The Bank does not expect the amendments to have a material impact on its consolidated financial statements.

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b) IAS 19 Employee Benefits (as amended in 2011), which changes the accounting for defined benefit plans and termination benefits. The most significant change relates to the accounting for changes in defined benefit obligations and plan assets. The amendments require the recognition of changes in defined benefit obligations and in fair value of plan assets when they occur, and hence eliminate the “corridor approach” permitted under the current version of IAS 19 (as revised in 2004) and accelerate the recognition of past service costs. The amendments require all actuarial gains and losses to be recognised immediately through other comprehensive income in order for the net pension asset or liability recognised in the consolidated statement of financial position to reflect the full value of the plan deficit or surplus. The revised IAS 19 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required with certain exceptions. The Bank does not expect the amendments to have a material impact on its consolidated financial statements.

c) Annual Improvements to IFRSs (issued in May 2012), which consist of various non-urgent but necessary amendments to several international financial reporting standards. If endorsed by the EU, these amendments will become mandatory for the Bank starting with its consolidated financial statements for the year 2013, with retrospective application required. The Bank does not expect the amendments to have a material impact on its consolidated financial statements.

d) IFRS 13 Fair value measurement, which defines fair value, establishes a single comprehensive framework for measuring fair value and sets out related disclosure requirements. IFRS 13 provides detailed fair value measurement application guidance and replaces the guidance currently included in individual IFRSs. In general, the disclosure requirements in IFRS 13 are more extensive than those required in the current standards. IFRS 13 must be applied to both financial and non-financial items whenever other IFRSs require or permit their measurement at fair value, except in specified circumstances. IFRS 13 will become mandatory for the Bank starting with its consolidated financial statements for the year 2013. The Bank will have to apply the measurement requirements of IFRS 13 prospectively as of the beginning of the year 2013 and it will have a choice as to whether it will provide the disclosures required by IFRS 13 for comparative periods. The Bank does not expect the amendments to have a material impact on its consolidated financial statements. More disclosures are however already anticipated.

e) Amendments to IAS 32 and IFRS 7 – Offsetting Financial Assets and Financial Liabilities. The amendments to IAS 32 clarify that an entity currently has a legally enforceable right to set-off if that right is (a) not contingent on a future event; and (b) enforceable both in the normal course of business and in the event of default, insolvency or bankruptcy of the entity and all counterparties. The amendments to IFRS 7 contain new requirements for disclosure of information that would enable users of financial statements to evaluate the effect or potential effect on an entity's financial position resulting from netting arrangements, including rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities. The amendments to IAS 32 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014 and the amendments to IFRS 7 starting with its consolidated annual and interim financial statements for the year 2013. Retrospective application is required for both amendments to IAS 32 and IFRS 7. The Bank does not plan to early adopt these amendments and is currently in the process of evaluating their impact on its consolidated financial statements. More disclosures are however already anticipated.

f) IFRS 10 Consolidated Financial Statements, which supersedes the requirements in IAS 27 Consolidated and Separate Financial Statements (as amended in 2008) relating to consolidated financial statements and SIC-12 Consolidation – Special Purpose Entities. IFRS 10 includes a revised definition of control that contains three elements: (a) power over an investee, (b) exposure, or rights, to variable returns from its involvement with the investee, and (c) the ability to use its power over the investee to affect the amount of the investor's returns. Extensive application guidance has been included in IFRS 10 to deal with complex circumstances, including guidance on how to determine when an investor holding less than a majority of the voting rights has de facto power over an investee. IFRS 10 carries forward the consolidation procedures from IAS 27 (2008). However, IFRS 10 will require parent companies which are investment entities to measure investments in particular subsidiaries at fair value through profit or loss instead of consolidating those subsidiaries. IFRS 10 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank does not plan to early adopt IFRS 10 and it is currently in the process of evaluating the possible impact of IFRS 10 on its consolidated financial statements. The application of IFRS 10 may result in the Bank no longer consolidating some of its investees and consolidating investees that were not previously consolidated.

Notes to the Consolidated Financial Statements

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g) IFRS 11 Joint Arrangements, which supersedes IAS 31 Interests in Joint Ventures and establishes principles for financial reporting by all entities that have interests in arrangements that are controlled jointly. Under IFRS 11, joint arrangements must be classified and accounted for either as joint operations or joint ventures. In contrast, under IAS 31, there are three types of joint arrangements: jointly controlled entities, jointly controlled assets and jointly controlled operations. In addition, joint ventures under IFRS 11 are required to be accounted for using the equity method of accounting, whereas jointly controlled entities under IAS 31 can be accounted for using either the equity method of accounting or proportionate accounting. Under IFRS 11, joint arrangements are classified depending on the rights and obligations of the parties to the arrangements. Joint operations arise where a joint operator has rights to the assets and obligations relating to the arrangement and hence accounts for its interest in assets, liabilities, revenue and expenses. Joint ventures arise where the joint operator has rights to the net assets of the arrangement and hence equity accounts for its interest. IFRS 11 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank does not plan to early adopt IFRS 11, which is otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

h) IFRS 12 Disclosure of Interests in Other Entities, which includes all the disclosure requirements for interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. In general, the disclosure requirements in IFRS 12 are more extensive than those in the currently effective standards. The disclosures required by IFRS 12 must enable users of an entity's financial statements to evaluate (a) the nature of, and risks associated with, the entity's interests in other entities; and (b) the effects of those interests on the entity's financial position, financial performance and cash flows. IFRS 12 will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required but subject to specific transitional relief. The Bank does not plan to early adopt IFRS 12 and it is currently in the process of evaluating the impact of IFRS 12 on its consolidated financial statements. More disclosures are however already anticipated.

i) IAS 28 Investments in Associates and Joint Ventures (as amended in 2011), which supersedes IAS 28 Investments in Associates (as revised in 2003) and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures. The majority of the amendments made to IAS 28 in 2011 result from the incorporation of the requirements for joint ventures into the standard. The fundamental approach to accounting for equity-accounted investments has not been changed. Accordingly, IAS 28 (2011) requires an entity with significant influence over, or joint control of, an investee to account for the investment in the associate or joint venture using the equity method, except when the investment qualifies for certain exemptions. IAS 28 (2011) clarifies that either the entire investment in an associate or a portion of it may be measured by the investor at fair value through profit or loss in accordance with IAS 39 Financial Instruments: Recognition and Measurement (or IFRS 9 Financial Instruments if adopted) if certain criteria are met. IAS 28 (2011) contains more specific provisions with respect to investments in associates and joint ventures which meet the criteria to be classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations. IAS 28 (2011) will become mandatory for the Bank starting with its consolidated financial statements for the year 2014, with retrospective application required. The Bank does not plan to early adopt IAS 28 (2011), which is otherwise not expected to have a material impact on the consolidated financial statements of the Bank.

j) IFRS 9 Financial Instruments replaces those parts of IAS 39 Financial Instruments: Recognition and Measurement relating to the classification and measurement of financial assets and financial liabilities. The key features of IFRS 9 are the following:

• Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.
• An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest. All other debt instruments are to be measured at fair value through profit or loss.
• All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There will be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

Notes to the Consolidated Financial Statements

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• Derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not to be separated; instead the hybrid financial instrument is to be assessed in its entirety as to whether it should be measured at amortised cost or fair value.

• IFRS 9 (2010) generally requires that the amount of change in fair value attributable to changes in the credit risk of liabilities designated by an entity as at fair value through profit or loss be presented in other comprehensive income, with only the remaining amount of the total gain or loss included in profit or loss. The amounts presented in other comprehensive income may not be subsequently reclassified to profit or loss but may be transferred within equity. However, if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, then the whole fair value change must be presented in profit or loss. Additionally, all fair value gains and losses continue to be included in profit or loss for loan commitments and financial guarantee contracts designated as fair value through profit or loss.

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

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

Notes to the Consolidated Financial Statements

Business combination

4. Acquisition of group undertakings

4.1 Merger with Kreditkort hf.

a) *Identification of the business*

At year end 2011, the Bank announced its intention to merge with its 100% owned subsidiary Kreditkort hf., a credit card company offering MasterCard and American Express in the Icelandic market. The merger was approved by the Financial Supervisory Authority (FME) on 30 March 2012 and the merger subsequently became effective from 1 April 2012. The two entities were combined under the Íslandsbanki hf. brand, but the Bank will continue to use the brand name Kreditkort for credit card operations.

b) *Identification of the merged assets and liabilities*

The fair value of the net identifiable assets and liabilities in Kreditkort hf. at the date of the merger equals its carrying amount as follows:

	1.4.2012
Cash and balances with Central Bank	37
Loans and receivables to customers	5,273
Investments in associates	9
Property and equipment	121
Tax assets	121
Other assets	82
Assets	5,643
Debt issued and other borrowed funds/Borrowings	4,878
Other liabilities	147
Liabilities	5,025
Net identifiable assets and liabilities	618

The cost arising from the merger was immaterial and no goodwill arose from the transaction.

The total fair value of loans and receivables was ISK 5,273 million, thereof receivables of ISK 29 million. The gross contractual amount for loans was ISK 5,843 million, of which ISK 599 million is expected to be uncollectible.

4.2 Loss of control of a subsidiary

On 14 January 2012 the Bank sold 82% of its shareholding in Jardboranir hf. The entity was classified as a non-current asset held for sale. The Bank has derecognised the assets and liabilities, any non-controlling interests and other components related to the subsidiary. Any surplus or deficit arising on the loss of control is recognised in profit or loss in the line item "Profit from discontinued operations, net of income tax". The retained 18% interest in the previous subsidiary was measured at fair value at the date that the control was lost and was subsequently accounted for as an equity-accounted investee.

4.3 Aquisition of subsidiaries held exclusively with a view to disposal

On 3 May 2012, the Bank acquired 100% shareholding in the equity investments company Geysir Green Investment Fund slhf. and Geysir General Partner ehf. The entities qualify as being held for sale in accordance with IFRS 5 and have therefore been classified as disposal groups held for sale.

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Notes to the Consolidated Financial Statements

Business segments

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

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

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

a) Retail Banking operates 21 branches and asset-based financing under the brand name Ergo. The branches provide services to individuals and small and medium-sized enterprises. In addition, the Retail Banking division operates Kreditkort, which is a special credit card branch, call center and centralised cash center.

b) Corporate Banking provides lending and other credit services to medium and large corporates in Iceland. In addition, Corporate Banking's Corporate Solutions unit, manages and leads restructuring of the distressed large corporate portfolio.

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

d) Wealth Management offers a range of wealth and asset management products and services for individuals, corporations and institutional investors. The Wealth Management unit consists of VÍB which offers a broad range of asset management products and services and the fund management company Íslandssjódir. Net valuation changes in Wealth Management derive from a small loan book in a winding down process.

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

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

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

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

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The year 2012

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	21,334	6,821	277	1,080	3,337	(243)	(1,371)	31,235
Net valuation changes	(1,444)	5,375	0	966	(0)	537	276	5,710
Net fee and commission income	3,393	112	1,865	1,574	(203)	2,549	169	9,459
Other net operating income (exps.)	(376)	(144)	642	64	3,250	2,740	779	6,955
Total operating income	22,907	12,164	2,784	3,684	6,384	5,583	(147)	53,359
Administrative expenses	(7,056)	(561)	(1,108)	(959)	(186)	(2,747)	(11,972)	(24,589)
Impairment of goodwill	-	-	-	(135)	-	-	(290)	(425)
Insurance fund	(913)	(0)	(0)	(74)	(68)	-	-	(1,055)
Share of profit of associates	-	-	-	-	-	-	-	-
Profit (loss) before cost allocation & tax	14,938	11,603	1,676	2,516	6,130	2,836	(12,409)	27,290
Net segment revenue from external customers	25,674	20,341	2,597	1,396	(3,084)	5,583	852	53,359
Net segment revenue from other segments	(2,767)	(8,177)	187	2,288	9,468	-	(999)	(0)
At 31 December 2012								
Total segment assets	379,450	199,948	954	5,808	195,005	101,945	(59,734)	823,376
Total segment liabilities	398,628	5,777	500	44,770	213,107	57,453	(44,520)	675,715

The year 2011

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	17,866	7,985	137	965	5,936	(1,608)	(56)	31,225
Net valuation changes	(6,897)	7,447	-	(1,863)	-	12	81	(1,220)
Net fee and commission income	2,548	184	1,181	1,404	(105)	559	195	5,966
Other net operating income (exps.)	41	2,548	(94)	172	591	1,085	137	4,480
Total operating income	13,558	18,164	1,224	678	6,422	48	357	40,451
Administrative expenses	(5,681)	(578)	(1,014)	(837)	(214)	(656)	(10,890)	(19,870)
Impairment of goodwill	-	-	-	-	-	-	(17,873)	(17,873)
Insurance fund	(855)	-	-	(63)	-	(46)	(1)	(965)
Share of profit of associates	-	-	-	-	39	-	-	39
Profit (loss) before cost allocation & tax	7,022	17,586	210	(222)	6,247	(654)	(28,407)	1,782
Net segment revenue from external customers	17,642	25,418	1,160	91	(5,043)	483	700	40,451
Net segment revenue from other segments	(4,084)	(7,254)	64	587	11,465	(435)	(343)	0
At 31 December 2011								
Total segment assets	364,835	184,300	1,105	7,175	193,311	116,875	(71,686)	795,915
Total segment liabilities	381,933	599	1,608	28,401	243,604	76,478	(60,411)	672,212

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Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters:

2012	Q4*	Q3*	Q2*	Q1*	Total
Net interest income	7,950	7,601	6,996	8,688	31,235
Net valuation changes on loans and receivables	3,704	713	3,613	(1,544)	6,486
Provision for latent impairment	(197)	(309)	(149)	(121)	(776)
Net fee and commission income	2,755	2,278	2,324	2,102	9,459
Net financial income	556	223	553	1,323	2,655
Net foreign exchange gain (loss)	1,760	665	(225)	1,104	3,304
Other net operating income	181	226	294	295	996
Administrative expenses	(6,701)	(5,271)	(6,395)	(6,222)	(24,589)
Impairment of goodwill	(425)	-	-	-	(425)
Contribution to the Depositors' and Investors' Guarantee Fund	(257)	(272)	(201)	(325)	(1,055)
Share of profit of associates net of tax	-	-	-	-	-
Profit before tax	9,326	5,854	6,810	5,300	27,290
Income tax	(1,790)	(1,465)	(1,546)	(1,452)	(6,253)
Bank tax	(227)	(224)	(200)	(207)	(858)
Profit for the period from continuing operations	7,309	4,165	5,064	3,641	20,179
(Loss) profit for the period from discontinued operations	(112)	432	954	1,965	3,239
Profit for the period	7,197	4,597	6,018	5,606	23,418

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

2011	Q4*	Q3*	Q2*	Q1*	Total
Net interest income	7,074	7,848	8,242	8,061	31,225
Net valuation changes on loans and receivables	(465)	(576)	409	(664)	(1,296)
Provision for latent impairment	64	167	16	(171)	76
Net fee and commission income	1,600	1,353	1,298	1,715	5,966
Net financial income (expenses)	2,986	131	(330)	(138)	2,649
Net foreign exchange gain	529	72	134	202	937
Other net operating (expenses) income	(74)	312	297	359	894
Administrative expenses	(6,118)	(4,378)	(4,671)	(4,703)	(19,870)
Impairment of goodwill	(17,873)	-	-	-	(17,873)
Contribution to the Depositors' and Investors' Guarantee Fund	(281)	(252)	35	(467)	(965)
Share of profit of associates net of tax	39	-	-	-	39
(Loss) profit before tax	(12,519)	4,677	5,430	4,194	1,782
Income tax	3,022	(1,030)	(1,202)	(865)	(75)
Bank tax	(173)	(165)	(289)	(55)	(682)
(Loss) profit for the period from continuing operations	(9,670)	3,482	3,939	3,274	1,025
Profit (loss) for the year from continuing operations	190	(198)	537	312	841
(Loss) profit for the period	(9,480)	3,284	4,476	3,586	1,866

* The half year results were reviewed by the Bank's auditors, with an emphasis on the loan portfolio, but the splits between quarters were not audited. The legislation for the Depositors' and Investors' guarantee fund was changed in June 2011 which resulted in an amendment to charged amounts.

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Notes to the Consolidated Financial Statements

Financial assets and liabilities

7. The following tables show the carrying value of financial assets and financial liabilities according to their IAS 39 classification.

At 31 December 2012	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	26	-	-	85,500	-	85,500
Loans and receivables						
Loans to credit institutions	31-32	-	-	54,043	-	54,043
Loans to customers	33-34	-	-	557,857	-	557,857
Loans and receivables		-	-	697,400	-	697,400
Bonds and debt instruments						
Listed		28,400	31,661	-	-	60,061
Unlisted			3,974	-	-	3,974
Bonds and debt instruments	29	28,400	35,635	-	-	64,035
Shares and equity instruments						
Listed		2,835	3,681	-	-	6,516
Unlisted		-	3,929	-	-	3,929
Shares and equity instruments	30	2,835	7,610	-	-	10,445
Derivatives	28	127	-	-	-	127
Other financial assets		-	-	1,259	-	1,259
Total financial assets		31,362	43,245	698,659	-	773,266
Derivative instruments and short positions	28	18,435	-	-	-	18,435
Deposits from Central Bank	44	-	-	-	54	54
Deposits from credit institutions	44	-	-	-	38,218	38,218
Deposits from customers	45-46	-	-	-	471,156	471,156
Debt issued and other borrowed funds	47	-	-	-	66,571	66,571
Subordinated loans	48	-	-	-	23,450	23,450
Other financial liabilities		-	-	-	23,494	23,494
Total financial liabilities		18,435	-	-	622,943	641,378

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7. Cont'd

At 31 December 2011	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	26	-	-	57,992	-	57,992
Loans and receivables						
Loans to credit institutions	31-32	-	-	43,655	-	43,655
Loans to customers	33-34	-	-	564,394	-	564,394
Loans and receivables		-	-	666,041	-	666,041
Bonds and debt instruments						
Listed		23,095	31,610	-	-	54,705
Unlisted		-	3,957	-	-	3,957
Bonds and debt instruments	29	23,095	35,567	-	-	58,662
Shares and equity instruments						
Listed		1,079	5,207	-	-	6,286
Unlisted		-	4,821	-	-	4,821
Shares and equity instruments	30	1,079	10,028	-	-	11,107
Derivatives	28	339	-	-	-	339
Other financial assets		-	-	2,199	-	2,199
Total financial assets		24,513	45,595	668,240	-	738,348
Derivative instruments and short positions	28	13,373	-	-	-	13,373
Deposits from Central Bank	44	-	-	-	73	73
Deposits from credit institutions	44	-	-	-	62,772	62,772
Deposits from customers	45-46	-	-	-	462,943	462,943
Debt issued and other borrowed funds	47	-	-	-	63,221	63,221
Subordinated loans	48	-	-	-	21,937	21,937
Other financial liabilities		-	-	-	17,210	17,210
Total financial liabilities		13,373	-	-	628,156	641,529

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Notes to the Consolidated Financial Statements

Fair value information for financial instruments

8. **Financial instruments at amortised cost**

Loans on the Bank's balance sheet that are carried at amortised cost consist of two components:

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

Loans in category 1) are valued specifically quarterly and therefore their fair value is fully represented by their carrying amount. The fair value of the loans in category 2) may differ from their carrying amount because the interest rate they carry may not reflect the interest rate that similar new loans would carry. This difference stems from two sources:
a) Credit migration: The debtors may not have the same credit-worthiness they had when the loans' interest rates were last reset.
b) Fixed rate loans: The interest rate level used as a base for pricing fixed rate loans may have shifted.

The Bank takes these effects into account for each loan by discounting the resulting interest rate difference from 31 December 2012 to that loan's next interest reset. At this time positive credit migrations balance out negative migrations. Furthermore, while nominal fixed rates have increased, a decrease in real rates counter-balances that effect. Thus the assessment is that the carrying amount of loans on the Bank's balance sheet fully represents their fair value.

On the liabilities side most deposits carry floating interest rates and their fair value equals their carrying amount. For longer term, fixed rate deposits, the Bank calculates the fair value with a duration approach, using the difference in each liability´s current rate from the estimated rate that a similar product would carry today. For "Debt issued and other borrowed funds" the Bank uses an observed market value where it is available while other debt is valued in the same manner as deposits.

For "Cash and balances with Central Bank" the carrying value is very well approximated by the carrying amount since they are very short term in nature. The liabilities in Subordinated loans carry floating interest rates and the Bank believes that in the current market environment it is very difficult to assess the funding rates of these instruments. There is no clear evidence that the funding premium has changed from the time of issuance of these loans. Therefore, their fair value equals their carrying amount.

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

	Carrying amount 2012	Fair value 2012	Carrying amount 2011	Fair Value 2011
Financial assets:				
Cash and balances with Central Bank	85,500	85,500	57,992	57,992
Loans to credit institutions	54,043	54,043	43,655	43,655
Loans to customers	557,857	557,857	564,394	564,394
Total financial assets	697,400	697,400	666,041	666,041
Financial liabilities:				
Deposits from Central Bank	54	54	73	73
Deposits from credit institutions	38,218	38,218	62,772	62,778
Deposits from customers	471,156	471,402	462,943	463,197
Debt issued and other borrowed funds	66,571	67,100	63,221	64,725
Subordinated loans	23,450	23,450	21,937	21,937
Total financial liabilities	599,449	600,224	610,946	612,710

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9. **Fair value hierarchy**

The table below categorises financial instruments carried at fair value, by valuation method used. The different levels have been defined as follows:

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

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

Level 3: Inputs for the assets or liabilities that are not based on observable market data unobservable inputs

The following table shows the level in the hierarchy into which the fair value of financial assets and liabilities carried at fair value in the consolidated balance sheet are categorised as at 31 December 2012:

At 31 December 2012

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	59,542	795	3,698	64,035
Shares and equity instruments	6,516	-	3,929	10,445
Derivative instruments	107	-	20	127
Total financial assets	66,165	795	7,647	74,607
Financial liabilities:				
Short positions	11,991	-	-	11,991
Derivative instruments	1,270	-	5,174	6,444
Total financial liabilities	13,261	-	5,174	18,435

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

At 31 December 2011

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	55,359	887	2,416	58,662
Shares and equity instruments	1,421	-	9,686	11,107
Derivative instruments	153	-	186	339
Total financial assets	56,933	887	12,288	70,108
Financial liabilities:				
Short positions	9,346	-	-	9,346
Derivative instruments	337	-	3,690	4,027
Total financial liabilities	9,683	-	3,690	13,373

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Notes to the Consolidated Financial Statements

Net interest income

10. Net interest income is specified as follows:

	2012	2011
Interest income:		
Cash and balances with Central Bank	3,467	1,449
Loans and receivables	52,571	49,217
Financial assets held for trading	(184)	541
Financial assets designated at fair value through profit or loss	1,742	1,336
Other assets	118	128
Total interest income	57,714	52,671
Interest expense:		
Deposits from credit institutions and Central Bank	(1,204)	(1,789)
Deposits from customers	(17,739)	(12,149)
Borrowings	(5,629)	(5,668)
Subordinated loans	(1,098)	(1,207)
Other financial liabilities	(546)	(392)
Other interest expense	(263)	(241)
Total interest expense	(26,479)	(21,446)
Net interest income	31,235	31,225
Interest spread (as the ratio of net interest income to the average carrying amount of total assets)	3.9%	4.5%

Net valuation changes on loans and receivables

11. Net valuation changes on loans and receivables:

	2012	2011
Impairment charged to the income statement:		
Specific impairment losses on financial assets	(18,253)	(16,545)
Impairment of foreign exchange gain	(1,044)	(5,081)
Net specific impairment losses on financial assets	(19,297)	(21,626)
Provision for latent impairment	(776)	76
Total impairment charged to the income statement (see Note 35)	(20,073)	(21,550)
Net valuation changes on loans and receivables:		
Income due to revised estimated future cash flow from loans	24,739	15,249
Net specific impairment losses on financial assets	(19,297)	(21,626)
Foreign exchange gain (see Note 16)	1,044	5,081
Net valuation changes on loans and receivables	6,486	(1,296)

Foreign exchange gain from customers with foreign exchange loans and cash flows in ISK is impaired and offset against total foreign exchange gain as per Note 16. Foreign exchange loss is recognised after previously impaired gain has been reversed.

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Notes to the Consolidated Financial Statements

Net fee and commission income

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

	2012	2011
Fee and commission income:		
Asset management	1,490	1,205
Investment Banking and brokerage	2,071	1,454
Payment processing	8,546	4,214
Loans and guarantees	1,104	906
Other fees and commissions income	1,601	919
Total fees and commission income	14,812	8,698
Commission expenses:		
Interbank charges	(232)	(536)
Brokerage	(165)	(143)
Clearing and settlement	(4,878)	(1,968)
Other commission expenses	(78)	(85)
Total commission expenses	(5,353)	(2,732)
Net fee and commission income	9,459	5,966

Net financial income

13. Net financial income is specified as follows:

	2012	2011
Net gain (loss) on financial assets and liabilities held for trading	841	(429)
Net gain on financial assets designated at fair value through profit or loss	1,814	3,136
Net loss on loss of control over subsidiary	-	(58)
Net financial income	2,655	2,649

Net gain (loss) on financial assets and liabilities held for trading

14. Net gain (loss) on financial assets and liabilities held for trading are specified as follows:

	2012	2011
Shares and related derivatives	318	52
Dividend income on shares held for trading	210	-
Bonds and related derivatives	313	(533)
Other derivatives	0	52
Net gain (loss) on financial assets and liabilities held for trading	841	(429)

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

15. Net gain on financial assets designated at fair value through profit or loss are specified as follows:

	2012	2011
Shares	2,150	3,151
Bonds	(336)	(15)
Net gain on financial assets designated at fair value through profit or loss	1,814	3,136

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Notes to the Consolidated Financial Statements

Net foreign exchange gain

16. Net foreign exchange gain is specified as follows:

	2012	2011
Assets:		
Cash and balances with Central Bank	60	25
Financial assets held for trading	967	(1,448)
Loans to credit institutions	4,043	2,217
Loans to customers	7,278	10,099
Other assets	280	52
Total	12,628	10,945
Liabilities:		
Deposits from credit institutions	(319)	(299)
Deposits from customers	(6,191)	(3,861)
Subordinated loan	(1,514)	(696)
Other liabilities	(256)	(71)
Total	(8,280)	(4,927)
Unadjusted net foreign exchange gain	4,348	6,018
Foreign exchange gain reversal on loans to customers with ISK cash flow*	(1,044)	(5,081)
Net foreign exchange gain	3,304	937

*Further discussed under Note 2.1 (c)

Other net operating income

17. Other net operating income is specified as follows:

	2012	2011
Agency fees and service level agreement fees	316	314
Rental income from real estate	76	127
Rental income from foreclosed assets	336	235
Legal cost and fees	101	83
Realised gain (loss) on property and equipment	4	(4)
Other net operating income	163	139
Other net operating income	996	894

Administrative expenses

18. Administrative expenses are specified as follows:

	2012	2011
Salaries and related expenses	13,080	10,531
Other administrative expenses	10,606	8,630
Depreciation	784	633
Amortisation	119	76
Administrative expenses	24,589	19,870

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Notes to the Consolidated Financial Statements

Salaries and related expenses

19. Salaries and related expenses are specified as follows:

	2012	2011
Salaries	10,118	8,456
Pension	1,379	1,152
Social security charges and financial activities tax	1,397	780
Other	186	143
Salaries and related expenses	13,080	10,531

The Bank made a provision of ISK 68 million for potential performance plan payments. In accordance with the FME rules 700/2011, part of the payment is deferred for a minimum of 3 years. Salary related expenses are included in the amount.

20. The Bank's total number of employees is as follows:

	At 31 December 2012		At 31 December 2011	
	Parent Company	The Bank	Parent Company	The Bank
Average number of employees	1,119	1,357	1,003	1,344
Positions at the end of the year	1,079	1,287	1,098	1,470

Average number of employees for the Bank in 2012 includes 113 employees (2011: 246 employees) in disposal groups held for sale, whose salaries are not included in the salaries and related expenses.

Employment terms for the Board of Directors, the CEO and Management Board

21. Employment terms for the Board of Directors, the CEO and Management Board are specified as follows:

2012	Salaries
Birna Einarsdóttir, CEO	31.5
Fridrik Sophusson, Chairman of the Board	7.2
Marianne Økland, member of the Board	5.6
Neil Graeme Brown, member of the Board	5.6
John E. Mack, member of the Board	5.7
Árni Tómasson, member of the Board	5.1
Daniel Levin, member of the Board	5.6
María E. Ingvadóttir, member of the Board	3.8
Kolbrún Jónsdóttir, former member of the Board	1.9
Alternate board members	1.0
7 Managing Directors	171.7
Total	244.7

2011	Salaries
Birna Einarsdóttir, CEO	29.7
Fridrik Sophusson, Chairman of the Board	6.3
Kolbrún Jónsdóttir, member of the Board	4.2
Neil Graeme Brown, member of the Board	4.6
John E. Mack, member of the Board	4.7
Árni Tómasson, member of the Board	4.2
Daniel Levin, member of the Board	3.3
Marianne Økland, member of the Board	4.7
Alternate board members	2.8
7 Managing Directors	145.2
Total	209.7

The employer's contribution to pension funds and other benefits for the Board, CEO and Management Board amounted to ISK 44.3 million in 2012 (2011: ISK 40.6 million). There were no share based payments in the years 2012 and 2011.

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Notes to the Consolidated Financial Statements

Auditors' fees

22. Auditors' fees are as follows:

	2012	2011
Audit of the annual accounts	84	112
Review of interim accounts	25	31
Other services	22	29
Auditors' fees	131	172
Thereof remuneration to others than the auditors of the parent company	31	25

Profit from discontinued operations

23. Profit from discontinued operations are specified as follows:

	2012	2011
Net profit from sale of foreclosed mortgages	590	436
Net share of loss from disposal groups held for sale	(155)	(840)
Net profit from sale of subsidiaries and associates	2,804	1,245
Profit from discontinued operations	3,239	841

Effective income tax

24. Income tax for the year 2012 is calculated at 20%. New tax, special financial activities tax (FAT) is calculated as 6% of taxable profits above ISK 1 billion. The effective income tax rate in the Bank's income statement for 2012 is 22.9%. The difference is specified as follows:

	2012		2011	
Profit before tax	27,290		1,782	
20% income tax calculated on the profit of the year	5,458	20.0%	356	20.0%
Special financial activities tax	954	3.5%	-	0.0%
Effect of different tax rate in other countries	(13)	(0.0%)	(38)	(2.1%)
Income not subject to tax	(459)	(1.7%)	(638)	(35.8%)
Non-deductable expenses	34	0.1%	144	8.1%
Other differences	279	1.0%	251	14.1%
Effective income tax	6,253	22.9%	75	4.2%

The Bank is taxed jointly with its subsidiary Íslandssjódir hf. whereby the taxable income of the subsidiary is added to the taxable income of the parent and taxed as one. Joint taxation is only applicable for calculation of income taxes. Tax losses brought forward which originate before the permission for a joint taxation was issued by the tax authorities cannot be used except to offset taxes of the entity where they originated.

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Earnings per share

25. Earnings per share are specified as follows:

Basic earnings per share, ISK Profit attributable to ordinary shareholders	2012	2011
Profit attributable to equity holders of the company for the year	20,199	1,117
Profit from discontinued operation attributable to equity holders of the company	3,239	841
	23,438	1,958
Average outstanding shares:		
Weighted average number of outstanding shares for the period, million	10,000	10,000
From continuing operations	2.02	0.11
From discontinued operations	0.32	0.08
From profit for the year	2.34	0.19
Diluted earnings per share, ISK		
Profit attributable to ordinary shareholders (diluted)		
Average outstanding shares for the calculation of diluted earnings per share	10,000	10,000
Number of total shares at the end of the period, million, diluted	10,000	10,000
From continuing operations	2.02	0.11
From discontinued operations	0.32	0.08
From profit for the year	2.34	0.19

There have been no transactions involving ordinary shares or potential ordinary shares between the reporting date and the date of the completion of these consolidated financial statements which would require the restatement of earnings per share.

Cash and balances with Central Bank

26. Specification of cash and balances with Central Bank:

	31.12.2012	31.12.2011
Cash on hand	2,008	1,976
Balances with Central Bank other than mandatory reserve deposits	16,221	14,587
Certificates of deposit	58,119	35,059
Included in cash and cash equivalents	76,348	51,622
Mandatory reserve deposits with Central Bank	9,152	6,370
Cash and balances with Central Bank	85,500	57,992

Mandatory reserve deposits are not available for use in the Bank's day-to-day operations.

Certificates of deposit (CDs) are a 28-day promissory notes issued by the Central Bank at fixed rates. The CD auction process is only for financial institutions with accounts at the Central Bank. The CDs may be used as collateral in collateralised lending transactions with the Central Bank.

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Pledged assets

		31.12.2012	31.12.2011
27.	Financial assets which have been pledged as collaterals for liabilities	95,034	76,597

The Bank has issued covered bonds under Icelandic law, with maturities of up to 12 years, which are pledged on a pool of consumer mortgage loans. The underlying cover pool must withstand a weekly stress test with regards to interest rates and exchange rates. The Bank also pledged a pool of customer loans as collateral for an asset-backed bond issued to the Central Bank of Iceland. Furthermore, the Bank pledged a pool of customer loans as collateral in a currency swap agreement with the Central Bank in order to reduce the Bank's foreign exchange imbalance and has also pledged cash collateral in foreign currency for International Swaps and Derivatives Association (ISDA) agreements with foreign financial institutions.

Derivative instruments and short positions

28. Derivative instruments and short positions:

At 31 December 2012	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	5	500	1,142	19,900
Cross currency interest rate swaps	20	7,199	5,094	55,351
Equity forwards	-	-	89	95
Foreign exchange forwards	8	1,503	8	219
Foreign exchange swaps	33	1,154	9	2,492
Bond forwards	61	2,250	22	1,325
Bond options	-	-	80	25,000
Derivatives	127	12,606	6,444	104,382
Short positions in listed bonds	-	-	11,991	-
Total	127	12,606	18,435	104,382

At 31 December 2011	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	25	3,100	107	10,750
Cross currency interest rate swaps	186	11,239	3,690	51,600
Equity forwards	6	82	6	30
Foreign exchange forwards	45	15,566	98	2,449
Foreign exchange swaps	59	4,889	13	1,516
Bond forwards	18	955	39	400
Bond options	-	-	74	25,000
Derivatives	339	35,831	4,027	91,745
Short positions in listed bonds	-	-	9,346	-
Total	339	35,831	13,373	91,745

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

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Notes to the Consolidated Financial Statements

28. Cont'd

Short positions are in listed government bonds. As a primary dealer the Bank has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the short positions have a maturity of less than a year and can be settled with cash on maturity of the bonds.

Bonds and debt instruments

29. Specification of bonds and debt instruments:

	31.12.2012	31.12.2011
Listed	60,061	54,705
Unlisted	3,974	3,957
Bonds and debt instruments	64,035	58,662

Shares and equity instruments

30. Specification of shares and equity instruments:

	31.12.2012	31.12.2011
Listed	6,516	6,286
Unlisted	3,929	4,821
Shares and equity instruments	10,445	11,107

Loans

31. Loans to credit institutions:

	31.12.2012	31.12.2011
Money market loans	17,581	16,706
Bank accounts	36,462	26,949
Loans to credit institutions	54,043	43,655

32. Loans to credit institutions at amortised cost:

			31.12.2012			31.12.2011
	Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance	Carrying amount
Loans to credit institutions:						
Loans	54,043	-	54,043	43,655	-	43,655
Total	54,043	-	54,043	43,655	-	43,655

33. Loans to customers:

	31.12.2012	31.12.2011
Loans and advances to customers at amortised cost	557,857	564,394
Loans to customers	557,857	564,394

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Notes to the Consolidated Financial Statements

34. Loans to customers at amortised cost:

At 31 December 2012

	Gross amount	Individually assessed impairment allowance	Collectively assessed impairment allowance	Loans less impairment allowance
Loans to customers:				
Individuals	254,461	(7,896)	(2,139)	244,426
Commerce and services	75,130	(5,761)	(564)	68,805
Construction	18,954	(1,576)	(913)	16,465
Energy	4,945	-	(3)	4,942
Financial services	282	(27)	(1)	254
Government secured customer loan	-	-	-	-
Industrials and transportation	46,773	(2,406)	(707)	43,660
Investment companies	21,943	(5,920)	-	16,023
Public sector and non-profit organisations	11,307	(329)	(44)	10,934
Real estate	86,849	(12,686)	(1,222)	72,941
Seafood	84,142	(2,959)	(38)	81,145
Loans to customers before latent impairment allowance				559,595
Latent impairment allowance				(1,738)
Loans to customers	604,786	(39,560)	(5,631)	557,857

At 31 December 2011

	Gross amount	Individually assessed impairment allowance	Collectively assessed impairment allowance	Loans less impairment allowance
Loans to customers:				
Individuals	235,150	(3,349)	(3,215)	228,586
Commerce and services	69,138	(3,818)	(1,254)	64,066
Construction	18,344	(2,531)	(1,088)	14,725
Energy	3,679	(167)	(1)	3,511
Financial services	1,405	(2)	-	1,403
Government secured customer loan	38,798	-	-	38,798
Industrials and transportation	37,400	(2,739)	(633)	34,028
Investment companies	29,252	(4,531)	(287)	24,434
Public sector and non-profit organisations	9,727	(111)	(61)	9,555
Real estate	90,538	(13,171)	(1,907)	75,460
Seafood	73,121	(2,316)	(62)	70,743
Loans to customers before latent impairment allowance				565,309
Latent impairment allowance				(915)
Loans to customers	606,552	(32,735)	(8,508)	564,394

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35. Financial assets - impairments

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

	Individually assessed	Collectively assessed	Latent	Total
At 1 January	32,735	8,508	915	42,158
Merger with Kreditkort	205	(252)	47	-
Amounts written-off	(12,643)	(46)	-	(12,689)
Recoveries of amounts previously written-off	2,136	-	-	2,136
Principal credit adjustment	(3,998)	(751)	-	(4,749)
Charged to the income statement	21,125	(1,828)	776	20,073
At 31 December 2012	39,560	5,631	1,738	46,929

	Individually assessed	Collectively assessed	Latent	Total
At 1 January	45,623	15,687	991	62,301
Reclass transaction 1 January	1,220	-	-	1,220
Amounts written-off	(31,132)	(1,071)	-	(32,203)
Period adjustments	(1,242)	93	-	(1,149)
Recoveries of amounts previously written-off	1,291	-	-	1,291
Principal credit adjustment	(3,248)	(7,604)	-	(10,852)
Charged to the income statement	20,223	1,403	(76)	21,550
At 31 December 2011	32,735	8,508	915	42,158

	2012	2011
Impairment losses charged to the income statement:		
Loans to customers	20,073	21,580
Loans to credit institutions	-	(30)
Impairment losses charged to the income statement	20,073	21,550

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Notes to the Consolidated Financial Statements

Investment in associates

36. Changes in investment in associates:

	31.12.2012	31.12.2011
Investments in associates at the beginning of the year	1,070	354
Acquisition of shares in associates	-	677
Sales of shares in associates	(567)	-
Share of results	-	39
Investment in associates	503	1,070

37. The Bank's interest in its principal associates are as follows:

	Ownership at year end
Eignarhaldsfélagid Fasteign hf., Bíldshöfda 9, 110 Reykjavík	40.0%
FAST GP ehf., Kirkjusandi 2, 155 Reykjavík	35.0%
Atorka Group hf., Túngötu 14, 101 Reykjavík	27.8%
Reiknistofa bankanna hf., Kalkofnsvegi 1, 150 Reykjavík	30.7%
Audkenni hf., Borgartúni 31, 105 Reykjavík	20.0%
5 other associates	

Summarised financial information in respect of the Bank's associates is set out below:

	31.12.2012	31.12.2011
Total assets	55,629	158,906
Total liabilities	(67,497)	(165,769)
Net assets	(11,868)	(6,863)
Bank's share of net assets of associates	503	1,070

	2012	2011
Total revenue	6,774	5,231
Total loss in associates for the year	(17,476)	(2,383)

When the Bank's share of losses in an associate exceeds its interest in the associate, the carrying amount of the investment is reduced to zero and the recognition of further losses is discontinued, except to the extent that the Bank has an obligation or has made payments on behalf of the associate.

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Investment in subsidiaries

38. Significant subsidiaries:

	Location	Ownership
Borgun hf., Ármúla 30, 108 Reykjavík	Iceland	62.2%
Íslandssjódir hf., Kirkjusandi 2, 155 Reykjavík	Iceland	100%
Midengi ehf., Lækjargötu 12, 155 Reykjavík	Iceland	100%
Höfdatorg ehf., Skúlagötu 63, 105 Reykjavík	Iceland	72.5%
Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur	Iceland	100%
Geysir Green Investment Fund slhf., Hafnargötu 90, Reykjanesbæ	Iceland	100%
Island Fund S.A. (formerly Glitnir Asset Management), 5 Allée Scheffer L-2520 Luxembourg	Luxembourg	99.9%
Glacier Geothermal and Seafood Corporation, 7 Times Square, Suite 1605 New York	USA	100%
34 other subsidiaries (SME)		

Related party disclosures

39. Ultimate controlling party

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

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

Related party transactions

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

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

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

			31.12.2012			31.12.2011
	Assets	Liabilities	Total	Assets	Liabilities	Total
CEO and Man. Directors (incl. comp. owned by them)	164	(246)	(82)	116	(279)	(163)
Members of the Board (incl. comp. owned by them)	391	(250)	141	376	(458)	(82)
Associated companies and other related parties	11,462	(8,649)	2,813	17,896	(11,012)	6,884
Total	12,017	(9,145)	2,872	18,388	(11,749)	6,639

	31.12.2012	31.12.2011
Guarantees	363	59
Loan commitments, overdrafts and credit card commitments	3,195	145

Impairment allowances of ISK 790 million (2011: ISK 4.100 million) were recognised during the year against balances outstanding with associated companies. No share option programmes were operated during 2012. For related party remuneration see Note 21.

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Notes to the Consolidated Financial Statements

Property and equipment

40. Property and equipment are specified as follows:

At 31 December 2012	Land and buildings	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	2,941	4,176	7,117
Additions during the year	367	1,014	1,381
Additions from acquired companies	66	-	66
Disposals during the year (write-offs)	(176)	(1,073)	(1,249)
Balance at 31.12.2012	3,198	4,117	7,315
Accumulated depreciation			
Balance at the beginning of the year	(14)	(1,827)	(1,841)
Depreciation during the year	(42)	(742)	(784)
Disposals during the year	5	884	889
Balance at 31.12.2012	(51)	(1,685)	(1,736)
Net book value at 31.12.2012	3,147	2,432	5,579
Depreciation rates	2%	8-33%	

Official real estate value of buildings and leased land	2,419
Insurance value of buildings as at 31.12.2012	4,156
Insurance value of fixtures, equipment and vehicles as at 31.12.2012	3,061

At 31 December 2011	Land and buildings	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	3,377	3,628	7,005
Additions during the year	-	874	874
Additions from acquired companies	242	4	246
Net acquisition through business combinations	972	114	1,086
Disposals during the year (write-offs)	-	(444)	(444)
Reclassifications	(1,650)	-	(1,650)
Balance at 31.12.2011	2,941	4,176	7,117
Accumulated depreciation			
Balance at the beginning of the year	(8)	(1,579)	(1,587)
Depreciation during the year	(6)	(627)	(633)
Disposals during the year	-	379	379
Balance at 31.12.2011	(14)	(1,827)	(1,841)
Net book value at 31.12.2011	2,927	2,349	5,276
Depreciation rates	2%	8-33%	

Official real estate value of buildings and leased land	2,146
Insurance value of buildings as at 31.12.2011	3,791
Insurance value of fixtures, equipment and vehicles as at 31.12.2011	2,723

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Notes to the Consolidated Financial Statements

Intangible assets

41. Intangible assets are specified as follows:

At 31 December 2012	Goodwill	Purchased software	Developed software	Total
Historical cost				
Balance at the beginning of the year	290	188	200	678
Additions	-	126	-	126
Acquistion through business combinations	135	-	-	135
Balance at 31.12.2012	425	314	200	939
Accumulated amortisation				
Balance at the beginning of the year	-	(101)	(33)	(134)
Amortisation during the year	-	(69)	(50)	(119)
Impairment of goodwill	(425)	-	-	(425)
Balance at 31.12.2012	(425)	(170)	(83)	(678)
Net book value at 31.12.2012	-	144	117	261
Amortisation rates		25%	25%	

At 31 December 2011	Goodwill	Purchased software	Developed software	Total
Historical cost				
Balance at the beginning of the year	-	159	86	245
Additions	-	29	114	143
Acquistion through business combinations	18,163	-	-	18,163
Balance at 31.12.2011	18,163	188	200	18,551
Accumulated amortisation				
Balance at the beginning of the year	-	(58)	-	(58)
Amortisation during the year	-	(43)	(33)	(76)
Impairment of goodwill	(17,873)	-	-	(17,873)
Balance at 31.12.2011	(17,873)	(101)	(33)	(18,007)
Net book value at 31.12.2011	290	87	167	544
Amortisation rates		25%	25%	

The impairment of goodwill in 2011 was based on uncertainty surrounding the recoverability of assets acquired in the merger with Byr in December 2011.

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Notes to the Consolidated Financial Statements

Non-current assets and disposal groups held for sale

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

	31.12.2012	31.12.2011
Repossessed collateral	10,161	10,467
Assets of disposal groups classified as held for sale	28,885	32,223
Total	39,046	42,690

Repossessed collateral:

	31.12.2012	31.12.2011
Land and property	8,225	7,683
Industrial equipment and vehicles	94	179
Shares and equity instruments	1,702	2,182
Vehicles	140	423
Total	10,161	10,467

The Bank classified the assets and liabilities of its subsidiaries Höfdatorg ehf., Fastengi ehf., Hafnargata 7 ehf., Bláfugl ehf., IG Invest ehf., Costa Properties ehf., Lava Capital ehf., Fjárvari ehf., Básbryggja ehf., Bréfabær ehf., Smyrlaheidi ehf., LT lódir ehf., Glitnir Real Estate Fund hf., Geysir Green Investment Fund slhf., Manston Properties Ltd. and Lava Capital Ltd. as assets and liabilities of disposal groups held for sale.

Shares and equity instruments comprise shares in the Bank's associates N1 hf. and Íslensk verdbréf hf. classified as non-current assets held for sale.

Assets of disposal groups classified as held for sale:

	31.12.2012	31.12.2011
Cash	1,069	1,212
Equipment	-	2,299
Equity instruments	1,037	-
Receivables	1,513	2,090
Tax assets	231	697
Properties	16,081	14,877
Assets classified as held for sale	4,937	6,129
Other assets	4,017	4,919
Total	28,885	32,223

Liabilities associated with assets classified as held for sale:

	31.12.2012	31.12.2011
Payables	634	1,237
Deferred tax liabilities	676	823
Borrowings	3,588	2,352
Other liabilities	1,907	2,905
Total	6,805	7,317

Other assets

43. Other assets are specified as follows:

	31.12.2012	31.12.2011
Receivables	2,740	3,351
Unsettled securities transactions	1,259	2,199
Accruals	562	494
Prepaid expenses	271	311
Inventory (real estate)	-	534
Other assets	283	668
Other assets	5,115	7,557

Inventory consists of real estate valued at the lower of cost and net realisable value.

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Notes to the Consolidated Financial Statements

Deposits from Central Bank and credit institutions

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

	31.12.2012	31.12.2011
Repurchase agreements with Central Bank	54	73
Deposits from credit institutions	38,218	62,772
Deposits from Central Bank and credit institutions	38,272	62,845

Deposits from customers

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

	31.12.2012	31.12.2011
Demand deposits	379,257	405,019
Time deposits	91,899	57,924
Deposits from customers	471,156	462,943

Demand deposits include deposits with maturity of up to 3 months.

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

		31.12.2012		31.12.2011
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	4,963	1%	14,362	3%
Municipalities	5,671	1%	7,054	2%
Other companies	276,168	59%	257,842	55%
Individuals	184,354	39%	183,685	40%
Deposits from customers	471,156	100%	462,943	100%

Debt issued and other borrowed funds

47. Specification of debt issued and other borrowed funds:

	31.12.2012	31.12.2011
Non-listed issued bonds	51,335	55,742
Listed issued bonds	13,713	3,855
Loans from credit institutions	8	333
Other debt securities	1,515	3,291
Debt issued and other borrowed funds	66,571	63,221

Non-listed bonds include an asset backed bond issued to the Central Bank of Iceland with maturity date in July 2019 which is pledged on a pool of loans to customers. Listed bonds are covered bonds pledged on a pool of consumer price indexed mortgage loans issued under Icelandic law. The Bank did not repurchase any of its own debt during 2012.

In March 2012, the Bank issued two new covered bond series. The two issues, which are both CPI-linked, were on the one hand a 7 year issuance, ISLA CBI 19, for an amount of ISK 1,830 million at a real yield of 2.84%, and on the other hand a 12 year issuance, ISLA CBI 24, for an amount of ISK 1,500 million at a real yield of 3.45%. The Bank tapped into these two outstanding issuances of covered bonds three times during the year 2012. In May, the Bank tapped into ISLA CBI 19 for an amount of ISK 635 million at a real yield of 2.90% and into ISLA CBI 24 for an amount of ISK 850 million at a real yield of 3.48%. In November, the Bank tapped into ISLA CBI 19 for an amount of ISK 400 million at a real yield of 2.80% and into ISLA CBI 24 for an amount of ISK 950 million at a real yield of 3.2%. In December, the Bank tapped into ISLA CBI 19 for an amount of ISK 610 million at a real yield of 2.72% and into ISLA CBI, for an amount of ISK 24 1,410 million at a real yield of 3.13%. At year end the total amount issued in ISLA CBI 19 and ISLA CBI 24 had reached ISK 3,475 million and ISK 4,710 million respectively. In October 2012, the Bank issued a new covered bond series. The issue was a 3-year non-indexed bond, ISLA CB 15, for an amount of ISK 1,240 million at a real yield of 6.5%.

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Notes to the Consolidated Financial Statements

Subordinated loans

48. Specification of subordinated loans:

	Currency	Interest	Maturity date	Book value 31.12.2012
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	EUR	4.2%	31.12.2019	23,450
Tier 2				23,450
Subordinated loans				23,450

	Currency	Interest	Maturity date	Book value 31.12.2011
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	EUR	5.4%	31.12.2019	21,937
Tier 2				21,937
Subordinated loans				21,937

Subordinated loans consists of a Tier 2 government bond of EUR 138 million.

Subordinated loans are financial liabilities of the Bank which consist of liabilities in the form of subordinated loan capital which, in case of the Bank's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio the subordinated loans are included within Tier II. Subordinated loans usually have a maturity of a minimum of 10 years. To ensure that the amount of capital outstanding doesn't fall sharply ,once a Tier II issue matures, the regulator demands that the subordinated issue is subjected to a progressive discount, of 20% per annum, during the last five years of its maturity.

Tax assets and tax liabilities

49. Tax in the balance sheet:

	31.12.2012 Assets	31.12.2012 Liabilities	31.12.2011 Assets	31.12.2011 Liabilities
Current tax	-	2,052	-	2,670
Deferred tax	864	20	2,629	17
Tax in the balance sheet	864	2,072	2,629	2,687

The deferred tax assets are mainly due to the write-off of goodwill in relation to the acquisition of Byr in December 2011. The goodwill is deductible for tax purposes over a period of 5 years.

50. Changes in the deferred tax assets and the tax liabilities during the year are as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2011	283	18
Acquisition through business combination	46	39
Calculated income tax for 2011	39	68
Income tax payable in 2012	2,299	(108)
Prior year income tax adjustment	(38)	-
Deferred tax assets and tax liabilities 1.1.2012	2,629	17
Calculated income tax for 2012	(4,972)	232
Income tax payable in 2013	3,380	(229)
Prior year income tax adjustment	(173)	-
Deferred tax assets and tax liabilities 31.12.2012	864	20

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Notes to the Consolidated Financial Statements

51. The Bank's deferred tax assets and tax liabilities are attributable to the following balance sheet items:

	31.12.2012			31.12.2011		
	Assets	Liabilities	Net	Assets	Liabilities	Net
Property and equipment	-	(225)	(225)	-	(190)	(190)
Shares in other companies	-	-	-	5	-	5
Assets and liabilities denominated in foreign currencies	-	(159)	(159)	-	(150)	(150)
Other intangible assets	2,154	-	2,154	2,844	-	2,844
Deferred foreign exchange difference	-	(973)	(973)	-	(218)	(218)
Other items	-	-	-	4	-	4
Tax loss carry forwards	47	-	47	317	-	317
	2,201	(1,357)	844	3,170	(558)	2,612
Set-off of deferred tax assets together with liabilities of the same taxable entities	(1,337)	1,337	-	(541)	541	-
Total	864	(20)	844	2,629	(17)	2,612

52. Movements in temporary differences during the year were as follows:

2012	Balance at 1.1.	Recognised in profit or (loss)	Changes from prior year	Balance at 31.12.
Property and equipment	(190)	(35)	-	(225)
Shares in other companies	5	(5)	-	-
Assets and liabilities denominated in foreign currencies	(150)	(9)	-	(159)
Other intangible assets	2,844	(690)	-	2,154
Deferred foreign exchange difference	(218)	(755)	-	(973)
Other items	4	(4)	-	-
Tax loss carry forwards	317	(245)	(25)	47
Total	2,612	(1,743)	(25)	844

2011	Balance at 1.1.	Recognised in profit or (loss)	Changes from prior year	Balance at 31.12.
Property and equipment	(156)	(34)	-	(190)
Shares in other companies	4	1	-	5
Assets and liabilities denominated in foreign currencies	(176)	26	-	(150)
Other intangible assets	(11)	2,855	-	2,844
Deferred foreign exchange difference	442	(660)	-	(218)
Other items	89	(85)	-	4
Tax loss carry forwards	73	198	46	317
Total	265	2,301	46	2,612

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Notes to the Consolidated Financial Statements

Other liabilities

53. Specification of other liabilities:

	31.12.2012	31.12.2011
Accruals	3,117	3,452
Liabilities to retailers for credit card provision	17,404	13,585
Provision for effects of court rulings*	14,736	10,982
Provision for estimated losses from guarantees**	868	578
Provision for reimbursement of interest***	2,493	-
Capital gains tax	1,896	1,888
Unsettled securities transactions	5,222	3,047
Deferred income	197	215
Sundry liabilities	3,021	4,142
Other liabilities	48,954	37,889

Provision:	Provision for effects of court rulings*	Provision for estimated losses from guarantees**	Provision for reimbursement of interest***	Total
Balance 1 January 2012	10,982	578	-	11,560
Provisions made during the year	7,636	290	2,493	10,419
Provision used during the year	(1,368)	-	-	(1,368)
Provisions reversed during the year	(2,514)	-	-	(2,514)
Balance at 31 December 2012	14,736	868	2,493	18,097

Equity

54. Share capital

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2012 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank.

Issued share capital

	31.12.2012	31.12.2011
Ordinary fully paid shares of ISK 1 krona each	10,000	10,000
Share capital	10,000	10,000

The Bank has one class of ordinary shares which carry no right to fixed income.

Share premium account

	31.12.2012	31.12.2011
Premium arising on issue of equity shares	55,000	55,000
Share premium account	55,000	55,000

Total share capital

	31.12.2012	31.12.2011
Ordinary share capital	10,000	10,000
Share premium account	55,000	55,000
Total share capital	65,000	65,000

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55. Other reserves are specified as follows:

	Other reserves
Other reserves as at 1.1.2011	2,498
Translation differences	163
Other reserves as at 31.12.2011	2,661
Translation differences	173
Other reserves as at 31.12.2012	2,834

Off-balance sheet items

56. Obligations:

The Bank has granted its customers guarantees, overdraft facilities and loan commitments as follows:

	31.12.2012	31.12.2011
Financial guarantees	8,371	6,893
Undrawn loan commitments	12,798	12,592
Undrawn overdrafts	22,412	21,449
Credit card commitments	27,710	22,202

The Depositors' and Investors' Guarantee Fund

Following an amendment in June 2012 to Law no. 98/1999 on the Depositors' and Investors' Guarantee Fund, the annual premium payable was decreased from 0.3% to 0.225% of all eligible deposits. In addition, there will be a variable premium payable based on equity, funding and a loan portfolio analysis (LPA) calculated as a ratio provided by the FME.

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

Operating lease commitments

57. Future non-cancellable minimum operating lease payments, where the Bank is the lessee, are due as follows:

	31.12.2012	31.12.2011
Up to 1 year	559	534
1-5 years	2,618	2,579
Later than 5 years	4,933	4,611
Operating lease commitments	8,110	7,724

The Bank leases a number of branch and office premises under operating leases. The typical lease period is 20 years with a continuation clause. In some leases the rent is based on the consumer price index and changes accordingly.

Balance of custody assets

58. Balance of custody assets:

	31.12.2012	31.12.2011
Custody assets	762,568	746,574

Custody assets are under custody, but not managed by the Bank.

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Notes to the Consolidated Financial Statements

Contingencies

59. **Litigation threats**

Several former customers of Glitnir private banking services have threatened litigation against the Bank in order to claim compensation for alleged mistakes made by former employees of Glitnir. A few of those customers have already filed lawsuits against the Bank with the Reykjavík District Court. The Bank has not accepted liability and will challenge these lawsuits on the grounds that these claims relate to events that happened prior to the incorporation of the Bank and the assignment of related liabilities and assets and are therefore not the responsibility of the Bank. The District Court has now ruled in favour of the Bank in one of these cases stating that the Bank cannot be held responsible for a mistake made by a former employee of Glitnir. This ruling was not appealed. The Bank estimates the total amount of compensation liabilities currently claimed by customers of Glitnir to be ISK 5.5 billion.

Netting agreement

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

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

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

Allocation of liens, guarantees and comparable rights

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

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

Indexed loans

Two court cases have been filed against the Housing Financing Fund (HFF) and Landsbankinn, challenging the legality of fixing the principal of a mortgage to the consumer price index (CPI). Such indexation has been the industry standard for at least 30 years. However, the method of calculating the index has changed over the years, with the most recent change introduced in 1995.

One of the cases is based on noncompliance with the law on consumer loans and will not address the legality of CPI indexation as such. The latter is based on the argument that CPI indexation makes a mortgage a complex financial instrument as defined in the Act on Securities Transactions no. 108/2007 (MiFid Directive) and therefore unsuitable for retail customers.

The possible effect on the Bank has not been estimated.

Foreign currency loans

Several rulings of the Supreme Court of Iceland during the years 2010 to 2013 in relation to foreign currency-linked loans have affected the Bank. Most important of these rulings was a ruling in June 2010 on the illegality of a principal of loans in ISK being linked to foreign currencies. Consequently, such loans could not carry Libor interest rates.

In order to address the uncertainty surrounding which foreign currency loans should be deemed to be illegally linked to foreign currency exchange rates, the Parliament introduced in 2010 a new legislation proposing a change to the Interest Law 38/2001. The legislation was passed as Amendment to the Interest Law 151/2010, taking effect on 28 December 2010. Based on the context of this new law, the Bank treated all foreign currency dominated mortgages and car loans according to the method previously set forth in a September 2010 ruling of the Supreme Court concerning car loans/leasing contracts. All customers with foreign currency mortgages were presented with an offer of having their mortgage recalculated according to a similar formula, regardless of the legality of the contract in question. The definition of a mortgage in the legislation refers to tax law. The recalculation had to be offered if the debtor was eligible for a refund in part of paid interest (interest subsidy) of the loan. The Bank decided to expand this definition to cover all residential loans to individuals, although the debtors were not required to accept the offer. The interest rate on car loans going forward was, according to the law, replaced by the lowest non-indexed Central Bank rate. The same goes for mortgages for the first five years, in addition to a choice of an indexed CPI rate. At the end of the five year term, mortgages will revert back to market rates.

59. Cont'd

Several court rulings have found additional loan contract types illegally indexed to foreign currency exchange rates. In April 2011, the District Court of Reykjavík ruled on a dispute regarding the nature of a financial leasing contract between the Bank and a customer. The court ruled that although the contract had the form of a lease, it was by nature a loan contract, thereby subject to the Interest Law 38/2001. The contract was denominated in foreign currency, and the court further ruled that the contract had an illegal foreign currency indexation, citing the precedent set by the Supreme Court in June 2010. In October 2011, the District Court ruling was confirmed by the Supreme Court. The ruling affected, by precedent, approximately 4,100 similar contracts. The Supreme Court set a new precedent in June 2011 by deciding that a Landsbankinn loan contract contained an illegal foreign currency indexation (MótorMax case).

In other cases, the courts have ruled that disputed contracts are indeed legal foreign currency loan contracts. On 3 November 2011, the Supreme Court ruled on an appeal of a District Court's decision to dismiss a case involving a disputed foreign currency bond (the box form). The Supreme Court ruled that because the disputed bond was by its nature not affected by the Supreme Court's previous rulings (including the June 2010 and 2011 rulings) the District Court should hear the case and pass a ruling of its own. The Supreme Court specifically mentions in the ruling that the bond's principal is stated in foreign currencies, and reiterates that a correctly written foreign currency debt agreement is not prohibited according to the Interest Law 38/2001. Consequently, the District Court ruled on the case as presented and found in favour of the Bank. In June 2012, the Supreme Court in effect confirmed this decision by ruling 7-0 on an identical loan contract. Furthermore, the Supreme Court decided in June 2012 that a loan contract similar to the one in the MótorMax case mentioned above was legal because the lender did actually receive payment in foreign currency.

On 15 February 2012, the Supreme Court in Iceland passed a ruling (no. 600/2011) that affects the recalculation of loans that are illegally linked to the value of foreign currencies. The ruling states that Act Law 151/2010, which the Icelandic Parliament passed in December 2010 and instructed banks on how to recalculate foreign currency linked mortgages, violates the provisions of the Icelandic constitution that protects the freedom to hold private property, as the legislator cannot pass a law that retroactively deprives a person of an asset without adequate compensation. More specifically, the Court ruled that the recalculation in the disputed case, which had been carried out as prescribed by Law 151/2012, was not appropriate. The Supreme Court passed on 18 October 2012 a new ruling on a similar case. The ruling gave to a certain extent instructions on how the disputed loans shall be recalculated. In both cases the amount of an outstanding loan was in dispute and the court found that borrowers that had made payments in line with instructions from the lender should not suffer a higher interest charge for payments already made. Internal and external legal counsel are unanimously of the opinion that the rulings affect loans to various types of borrowers, including individuals, corporate and municipalities and both long and short term loans.

The most recent Supreme Court ruling from 17 January 2013 on a currency loan involved an Íslandsbanki loan contract. The loan amount was denominated in ISK and the loan was disbursed to the customer in ISK, with the exception of one document/annex named “loan application” in which the loan amount was presented in foreign currencies. The court found that this document could not change or offset the illegal nature of the contract, mainly because the contract itself did not refer to any such document, (technically, every such contract has an annex named “disbursement notice”, but this was scarcely used as the opinion was that the loan application did serve more or less the same purpose). The ruling affected at least 300 loan contracts, some of which had previously been recalculated according to the offers made by the Bank. However, despite being relatively few in number, these type of contracts generally carry the greatest loan amounts.

The effects of these rulings and the subsequent corrections to the recalculations of illegal foreign currency-linked loans are reflected in the value of the loans in the Bank's consolidated financial statements, with the exception of the loans deemed illegal by the January 2013 ruling. With regard to those loans, the Bank has estimated the effects of the ruling and recognised a provision of ISK 6.5 billion at year end 2012. The amount owed to customers with regards to paid-up loans is reflected in the Bank's provisions, see Note 53.

These court rulings have gradually reduced the uncertainty regarding which foreign currency loans are illegal. The Bank has made an announcement to the effect that it will recalculate illegally foreign currency-linked and outstanding as well as paid-up loans in line with the instructions given in the most recent ruling. However, finding that the ruling is based on the Bank being the dominant and expert party in the contractual relationship, the ruling does not necessarily apply to other financial institutions or large companies as counterparties, especially if those conduct their business in part abroad or deal in foreign currency contracts on a regular basis.

Formal investigation by the EFTA Surveillance Authority regarding alleged government aid granted by the Icelandic government to investment funds and associated fund management companies connected to the three failed Icelandic banks Glitnir, Kaupthing and Landsbanki

On 11 July 2012 the EFTA Surveillance Authority (the Authority) concluded that state aid was indeed provided in October 2008 when the three new Icelandic banks were established and acquired assets held by eight investment funds. With reference to the serious disturbance in the Icelandic economy at the time the Authority finds this state aid compatible with the EEA Agreement.

The Authority considers that the state aid is compatible with Article 61(3)(b) of the EEA Agreement that allows for aid to remedy a serious disturbance in the economy. In October 2008, the financial sector in Iceland had collapsed and the government had to implement extraordinary measures in an attempt to stabilise the economy. The Authority considers that the measures at issue were necessary in order to try to restore faith in the financial sector. It was in that regard necessary and proportionate to protect the investors from even bigger losses on their savings.

59. Cont'd

Formal investigation by the EFTA Surveillance Authority into government aid granted in the restoration of certain operations of Glitnir and the establishment and capitalisation of Íslandsbanki

On 26 June 2012 the EFTA Surveillance Authority approved the state aid granted for the restructuring of Íslandsbanki.

With regard to the long-term viability of the Bank, the Authority emphasised in its decision that while challenges remain for the Bank and the Icelandic economy in general, the Bank has addressed the weaknesses of its predecessor. The Bank today has a strong capital ratio and has made good progress regarding the restructuring of loans to over-indebted customers. The Authority also took notice of numerous legislative amendments that Iceland has made since the collapse of the financial sector in 2008 which have strengthened the regulatory framework for financial institutions in Iceland.

The Bank and the government have committed to a range of conditions that limit distortions of competition. During the restructuring period which ends on 15 October 2014, the Bank is not permitted to acquire other financial institutions without the Authority´s approval. Furthermore, the Bank will continue to divest businesses and shareholdings. The Bank will also provide information for customers on its website on the process and the documentation needed for switching banking services to another financial institution.

Notes to the Consolidated Financial Statements

Risk management

60. **Risk governance**

The Bank is exposed to various risks. Managing these risks is an integral part of the Bank's operations.

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 risk appetite statement.

The implementation of the risk management framework, limit setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee (ALCO), the Executive Board and the Investment Committee. The members of those boards are appointed by the CEO.

The Risk Committee is responsible for supervising and monitoring the Bank's credit and credit concentration risks on a consolidated basis. The Risk Committee governs the Bank's credit policies and procedures. The Risk Committee can delegate authorisation power to its subcommittees.

The ALCO supervises the Bank´s other financial risks including market risk, liquidity risk, and the Bank's capitalisation. The ALCO decides on and sets limits for these risks and the Bank´s capital allocation framework.

The Executive Board is responsible for the operational risk framework and for managing other risk factors such as reputational risk and business risk.

The Investment Committee makes decisions pertaining to the purchase or sale of equity stakes in companies as well as other types of investments such as investment funds and real estate.

The Chief Risk Officer (CRO) is a member of the Executive Board and is responsible for the risk management organisation within Íslandsbanki. The CRO heads the Risk Management and Credit Control. The CRO is also responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills.

The compliance function is responsible for ensuring that the processes and the business conducted within the Bank are in accordance with external laws and regulations and internal directives and instructions.

Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

Credit risk

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

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

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

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

The Bank has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Bank'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 Bank'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 Bank 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 Bank 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 Bank 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.

Notes to the Consolidated Financial Statements

61. Cont'd

Changes have been made on the notes on maximum credit exposure, neither past due nor impaired loans, and past due but not impaired loans from last year's financial statements. Maximum credit risk exposure for on-balance sheet assets is now the net carrying amount as reported in the statement of financial position before the latent impairment allowance is subtracted. The internal credit rating is shown for loans that are neither past due nor impaired. Loans past due for three days or less are now omitted in the note on past due but not impaired loans.

62. Restructuring and forbearance

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

The Bank has offered several debt relief measures and restructuring frameworks for its customers since its establishment. These restructuring frameworks include principal adjustment and recalculation of currency linked loans, debt adjustment for companies and individuals, 110% adjustment of mortgages, interest discount, write-offs and tailor made solutions in complicated cases where general solutions do not suffice. In some cases, often prior to formal restructuring, customers undergo less formal forbearance measures such as temporary payment holidays, extension of loans terms and capitalisation of arrears.

This has been done without a significant loss to the Bank because the loan portfolio was acquired at a deep discount. The Bank has furthermore offset any foreign exchange gain or loss due to currency movements relating to loans to customers with ISK cash flow. More details on the accounting policies regarding impairment on loans can be seen in Note 3.23(a).

Further details on forbearance and the restructuring of customers can be seen in the Íslandsbanki's Risk Report which is published concurrent to the annual report.

63. Maximum credit exposure

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

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

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

Credit risk exposure

63. Cont'd

Maximum credit exposure 31.12.2012

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Government secured customer loan	Industrials and transporta-tion	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	85,500	-	-	-	-	-	-	-	-	-	-	85,500
Derivatives	8	132	51	30	-	1,292	-	12	70	-	8	36	1,639
Bonds and debt instruments	-	58,141	316	-	-	2,174	-	-	2,162	19	1,223	-	64,035
Loans to credit institutions	-	-	-	-	-	54,043	-	-	-	-	-	-	54,043
Loans to customers:	244,426	0	68,805	16,465	4,942	254	-	43,660	16,023	10,934	72,941	81,145	559,595
Overdrafts	14,871	-	6,487	2,705	3	94	-	3,508	418	1,756	1,616	1,898	33,356
Credit cards	15,825	0	1,243	138	2	26	-	333	34	182	45	41	17,869
Mortgages	164,416	-	-	-	-	-	-	-	-	-	-	-	164,416
Leases	9,763	-	14,187	2,266	14	13	-	4,181	176	408	1,492	413	32,913
Other loans	39,551	-	46,888	11,356	4,923	121	-	35,638	15,395	8,588	69,788	78,793	311,041
Off-balance sheet items:													
Financial guarantees	1,307	-	2,242	1,858	4	1,001	-	873	360	55	152	519	8,371
Undrawn loan commitments	-	-	3,308	422	5,436	-	-	2,798	1	-	-	833	12,798
Undrawn overdrafts	9,502	-	4,330	1,141	229	1,318	-	3,117	279	1,146	471	879	22,412
Credit card commitments	21,893	10	2,990	426	17	93	-	796	123	1,096	154	112	27,710
Total maximum credit exposure	277,136	143,783	82,042	20,342	10,628	60,175	-	51,256	19,018	13,250	74,949	83,524	836,103

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63. Cont'd

Maximum credit exposure 31.12.2011

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Government secured customer loan	Industrials and transporta-tion	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	57,992	-	-	-	-	-	-	-	-	-	-	57,992
Derivatives	10	58	71	54	2	1,161	-	13	41	-	1	70	1,481
Bonds and debt instruments	-	52,217	282	-	-	4,077	-	-	1,137	89	849	11	58,662
Loans to credit institutions	-	-	-	-	-	43,655	-	-	-	-	-	-	43,655
Loans to customers:	228,586	-	64,066	14,725	3,511	1,403	38,798	34,028	24,434	9,555	75,460	70,743	565,309
Overdrafts	14,531	-	6,647	3,528	28	1,187	-	3,563	489	1,289	1,075	1,202	33,539
Credit cards	15,796	-	1,569	129	5	17	8	194	22	117	39	30	17,926
Mortgages	140,762	-	-	-	-	-	-	-	-	-	-	-	140,762
Leases	11,196	-	8,921	2,749	16	8	-	3,709	193	773	1,190	552	29,307
Other loans	46,301	-	46,929	8,319	3,462	191	38,790	26,562	23,730	7,376	73,156	68,959	343,775
Off-balance sheet items:													
Financial guarantees	1,058	-	1,443	1,577	4	1,012	-	1,055	12	73	339	320	6,893
Undrawn loan commitments	-	-	2,017	-	5,345	5,000	-	225	-	-	-	5	12,592
Undrawn overdrafts	9,797	-	4,343	1,083	203	1,363	-	1,993	72	1,096	513	986	21,449
Credit card commitments	19,392	-	1,521	272	5	48	10	352	81	380	68	73	22,202
Total maximum credit exposure	258,843	110,267	73,743	17,711	9,070	57,719	38,808	37,666	25,777	11,193	77,230	72,208	790,235

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64. Collateral

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

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

Valuation of collateral is based on market price, official valuation from the Iceland Property Registry or expert opinion of the Bank's employees, depending on availability. In the case of fishing vessels, the associated fishing quota is included in the valuation. Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, the excess is removed in order to reflect the Bank's actual maximum exposure to credit risk. An estimate of the collateral held by the Bank against credit exposure is shown below:

At 31 December 2012	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Total collateral
Derivatives	-	-	640	-	-	640
Loans and commitments to customers:	314,242	68,349	15,682	17,790	14,231	430,294
Individuals	197,187	89	2,918	8,145	-	208,339
Commerce and services	27,477	-	913	8,471	3,083	39,944
Construction	7,622	186	121	287	3,662	11,878
Energy	2,601	-	6	3	146	2,756
Financial services	69	-	8	11	-	88
Government secured customer loan	-	-	-	-	-	-
Industrial and transportation	13,036	-	724	674	5,793	20,227
Investment companies	3,493	-	10,150	17	397	14,057
Public sector and non-profit organisations	3,645	-	10	59	194	3,908
Real estate	54,596	139	233	76	-	55,044
Seafood	4,516	67,935	599	47	956	74,053
Total	314,242	68,349	16,322	17,790	14,231	430,934

At 31 December 2011	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Total collateral
Derivatives	-	-	600	-	-	600
Loans and commitments to customers:	268,925	62,382	51,530	4,696	14,325	401,858
Individuals	170,491	71	1,148	3	-	171,713
Commerce and services	15,728	-	725	4,387	6,117	26,957
Construction	7,757	-	457	21	1,249	9,484
Energy	2,517	-	83	-	149	2,749
Financial services	44	-	47	-	-	91
Government secured customer loan	-	-	38,799	-	-	38,799
Industrial and transportation	7,362	-	294	283	5,420	13,359
Investment companies	2,933	-	8,901	-	389	12,223
Public sector and non-profit organisations	3,455	-	9	-	200	3,664
Real estate	54,679	154	675	-	-	55,508
Seafood	3,959	62,157	392	2	801	67,311
Total	268,925	62,382	52,130	4,696	14,325	402,458

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64. Cont'd

The Bank is still in the process of finalising the registration of necessary collateral information for this disclosure. During the reporting period, the Bank obtained a third party collateral valuation for a part of the leasing portfolio explaining the increase seen for vehicles and equipment in the table above.

65. Credit quality of financial assets

Loans are classified as impaired loans if contractual cash payments are not expected to be fulfilled and if financial restructuring of the obligor is expected to lead to a loss on that particular loan. In most cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio. Loans are also classified as impaired if the Bank has made impairments to offset currency movements. This impairment does not signal a loss exceeding the deep discount.

The full carrying amount of all loans which give rise to individual impairment or collective impairment is included in impaired loans, even if parts are covered by collateral. Latent impairment of 1,738 million in 2012 (2011: 915 million) has not been subtracted from the carrying amount in the tables below and derivatives include future credit exposure to the market value of the contract.

	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
At 31 December 2012				
Cash and balances with Central Bank	85,500	-	-	85,500
Derivatives	1,639	-	-	1,639
Bonds and debt instruments	64,035	-	-	64,035
Loans to credit institutions	54,043	-	-	54,043
Loans to customers:	469,435	42,205	47,955	559,595
Individuals	206,255	29,714	8,457	244,426
Commerce and services	55,908	3,330	9,567	68,805
Construction	13,411	1,717	1,337	16,465
Energy	4,941	-	1	4,942
Financial services	197	16	41	254
Government secured customer loan	-	-	-	-
Industrial and transportation	39,531	1,454	2,675	43,660
Investment companies	11,736	631	3,656	16,023
Public sector and non-profit organisations	10,425	101	408	10,934
Real estate	51,351	4,598	16,992	72,941
Seafood	75,680	644	4,821	81,145
Total	674,652	42,205	47,955	764,812

	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
At 31 December 2011				
Cash and balances with Central Bank	57,992	-	-	57,992
Derivatives	1,481	-	-	1,481
Bonds and debt instruments	58,662	-	-	58,662
Loans to credit institutions	43,655	-	-	43,655
Loans to customers:	413,849	66,491	84,969	565,309
Individuals	180,399	37,860	10,327	228,586
Commerce and services	44,234	6,397	13,435	64,066
Construction	6,110	4,255	4,360	14,725
Energy	2,927	28	556	3,511
Financial services	168	176	1,059	1,403
Government secured customer loan	38,798	-	-	38,798
Industrial and transportation	25,378	2,148	6,502	34,028
Investment companies	8,545	3,381	12,508	24,434
Public sector and non-profit organisations	5,799	307	3,449	9,555
Real estate	36,612	9,097	29,751	75,460
Seafood	64,879	2,842	3,022	70,743
Total	575,639	66,491	84,969	727,099

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66. Neither past due nor impaired loans

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

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

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

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

	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Total
At 31 December 2012						
Loans to customers - total						
Individuals	8,215	71,069	66,147	49,650	11,174	206,255
Commerce and services	3,737	14,624	21,225	10,326	5,996	55,908
Construction	-	1,511	9,062	2,117	721	13,411
Energy	2	2,882	24	2,033	-	4,941
Financial services	5	16	99	77	-	197
Government secured customer loan	-	-	-	-	-	-
Industrial and transportation	10,494	18,062	7,432	2,937	606	39,531
Investment companies	661	7,092	1,358	1,812	813	11,736
Public sector and non-profit organisations	639	4,994	2,000	2,774	18	10,425
Real estate	4,443	15,369	10,643	4,553	16,343	51,351
Seafood	31,949	34,605	5,638	705	2,783	75,680
Total	60,145	170,224	123,628	76,984	38,454	469,435

Breakdown of neither past due nor impaired loans is now disclosed for the first time. Comparative information is not available. Note that the same customer can have loans that are more than 90 days past or impaired, and at the same time other loans that are neither past due nor impaired. Those customers will be in risk class 10 and their loans that are neither past due nor impaired are included in the table above.

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67. Past due but not impaired loans

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

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

At 31 December 2012	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:					
Individuals	8,567	4,652	1,107	15,388	29,714
Commerce and services	1,023	502	101	1,704	3,330
Construction	323	82	97	1,215	1,717
Energy	-	-	-	-	-
Financial services	1	1	1	13	16
Government secured customer loan	-	-	-	-	-
Industrials and transportation	299	269	72	814	1,454
Investment companies	73	30	38	490	631
Public sector and non-profit organisations	42	19	-	40	101
Real estate	580	1,528	133	2,357	4,598
Seafood	45	30	34	535	644
Total	10,953	7,113	1,583	22,556	42,205

At 31 December 2011	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:					
Individuals	10,578	4,198	2,011	21,073	37,860
Commerce and services	1,311	394	435	4,257	6,397
Construction	1,337	290	287	2,341	4,255
Energy	14	-	-	14	28
Financial services	54	-	-	122	176
Government secured customer loan	-	-	-	-	-
Industrials and transportation	44	377	110	1,617	2,148
Investment companies	330	41	5	3,005	3,381
Public sector and non-profit organisations	174	24	11	98	307
Real estate	760	247	335	7,755	9,097
Seafood	92	29	66	2,655	2,842
Total	14,694	5,600	3,260	42,937	66,491

Íslandsbanki hf. Consolidated Financial Statements 2012 74 Amounts are in ISK million

68. Large exposure disclosure

When the Bank's total exposure to a group of connected clients is 10% of the Bank's capital base, or higher, it is considered a large exposure. The exposure is evaluated net of credit risk mitigating effects eligible according to the FME rules 216/2007.

When assessing the exposure, both on-balance sheet and off-balance sheet items from all types of financial instruments are included as defined by the FME rules. The Bank has internal criteria that defines connections between clients. This criteria reflects the Bank's interpretation of Article (1)(a) of Law 161/2002 on Financial Undertakings, where groups of connected clients are defined.

The Bank has one large exposure to a group of connected clients that amounts to 15% of the Bank's capital base which is below the aggregated 400% limit set by the law for exposures above 10% of the Bank's capital base. No large exposure exceeds the maximum 25% set by the law.

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

	31.12.2012		31.12.2011	
Client groups	Gross	Net	Gross	Net
Group 1	53%	0%	56%	0%
Group 2	15%	15%	27%	0%
Group 3	0%	0%	15%	15%

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Liquidity risk

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

Liquidity risk management

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

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

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

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

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

Maturity analysis 31 December 2012

Financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	11,991	-	-	-	-	-	11,991
Deposits from Central Bank	54	-	-	-	-	-	54
Deposits from credit institutions	29,726	8,119	401	-	-	-	38,246
Deposits from customers	338,464	46,390	41,059	27,590	23,969	-	477,472
Debt issued and other borrowed funds	8	2,449	7,304	44,288	23,085	983	78,117
Subordinated loans	-	236	523	6,337	28,919	-	36,015
Other financial liabilities	42,190	5,957	2,154	-	291	-	50,592
Total	422,433	63,151	51,441	78,215	76,264	983	692,487

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

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	8,371	-	-	-	-	-	8,371
Undrawn loan commitments	12,798	-	-	-	-	-	12,798
Undrawn overdraft	22,412	-	-	-	-	-	22,412
Credit card commitments	27,710	-	-	-	-	-	27,710
Total	71,291	-	-	-	-	-	71,291

Total non-derivative financial liabilities and off-balance sheet liabilities	493,724	63,151	51,441	78,215	76,264	983	763,778

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

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	6,074	1,872	75,987	25,000	-	108,933
Outflow	-	(5,849)	(1,944)	(93,004)	(25,080)	-	(125,877)
Total	-	225	(72)	(17,017)	(80)	-	(16,944)
Net settled derivatives	-	(115)	-	-	-	-	(115)
Total	-	110	(72)	(17,017)	(80)	-	(17,059)

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

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	27,380	58,120	-	-	-	-	85,500
Bonds and debt instruments	1,281	26,730	-	-	31,120	4,904	64,035
Shares and equity instruments	-	-	13	326	-	10,106	10,445
Loans to credit institutions	34,665	19,227	151	-	-	-	54,043
Loans to customers	578	70,346	50,267	149,005	289,399	-	559,595
Other financial assets	1,640	1,007	209	1,201	-	1,998	6,055
Total financial assets	65,544	175,430	50,640	150,532	320,519	17,008	779,673
Derivative financial assets							
Gross settled derivatives							
Inflow	-	1,805	909	8,284	-	-	10,998
Outflow	-	(1,755)	(860)	(8,189)	-	-	(10,804)
Total	-	50	49	95	-	-	194
Net settled derivatives	-	61	-	-	-	-	61
Total	-	111	49	95	-	-	255

The tables below show the comparative amounts for financial assets and liabilities at the end of 2011. In the consolidated financial statement 2011, internal derivatives were included in financial assets and liabilities. This has been amended in the table below.

Maturity analysis 31 December 2011

Financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	9,346	-	-	-	-	-	9,346
Deposits from Central Bank	73	-	-	-	-	-	73
Deposits from credit institutions	49,527	12,209	1,077	-	-	-	62,813
Deposits from customers	351,478	53,730	28,670	25,411	12,907	-	472,196
Debt issued and other borrowed funds	333	2,226	7,108	43,423	27,381	2,145	82,616
Subordinated loans	-	298	559	6,124	38,288	-	45,269
Other financial liabilities	22,379	13,188	3,156	570	392	148	39,833
Total financial liabilities	433,136	81,651	40,570	75,528	78,968	2,293	712,146

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Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	6,893	-	-	-	-	-	6,893
Undrawn loan commitments	12,592	-	-	-	-	-	12,592
Undrawn overdraft	21,449	-	-	-	-	-	21,449
Credit card commitments	22,202	-	-	-	-	-	22,202
Total	63,136	-	-	-	-	-	63,136
Total non-derivative financial liabilities and off-balance sheet liabilities	496,272	81,651	40,570	75,528	78,968	2,293	775,282

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	6,258	2,498	78,562	25,000	-	112,318
Outflow	-	(6,131)	(2,979)	(94,688)	(25,074)	-	(128,872)
Total	-	127	(481)	(16,126)	(74)	-	(16,554)
Net settled derivatives	-	(38)	-	-	-	-	(38)
Total	-	89	(481)	(16,126)	(74)	-	(16,592)

Financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	22,937	35,055	-	-	-	-	57,992
Bonds and debt instruments	6,617	16,494	82	152	31,361	3,956	58,662
Shares and equity instruments	-	-	525	48	-	10,534	11,107
Loans to credit institutions	22,027	21,556	-	-	72	-	43,655
Loans to customers	-	50,687	47,029	170,383	298,125	-	566,224
Other financial assets	-	2,567	237	2	-	380	3,186
Total financial assets	51,581	126,359	47,873	170,585	329,558	14,870	740,826
Derivative financial assets							
Gross settled derivatives							
Inflow	-	8,069	773	33,058	-	-	41,900
Outflow	-	(7,976)	(692)	(32,860)	-	-	(41,528)
Total	-	93	81	198	-	-	372
Net settled derivatives	-	21	-	-	-	-	21
Total	-	114	81	198	-	-	393

As a part of managing liquidity risk, the Bank holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Bank's liquidity back-up at the end of 2012 and end of 2011. The liquidity facility line with the Government expired at end of September and is therefore no longer included in the Bank's liquid assets at end of 2012.

Composition and amount of liquidity back-up	31.12.2012	31.12.2011
Cash and balances with Central Bank	85,500	57,992
Domestic bonds eligible as collateral against borrowing at the Central Bank	12,704	55,024
Foreign government bonds	26,730	16,323
Short-term placements with credit institutions	49,264	36,695
Government liquidity facility	-	25,000
Composition and amount of liquidity back-up	174,198	191,034

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Market risk

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

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

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

Interest rate risk

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

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

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

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

Trading bonds and debt instruments, long positions	31.12.2012			31.12.2011		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	1,589	11.01	(1.75)	379	9.22	(0.35)
Non-Indexed	26,933	0.18	(0.50)	17,231	0.32	(0.55)
Total	28,522	0.79	(2.25)	17,610	0.51	(0.90)

Trading bonds and debt instruments, short positions	31.12.2012			31.12.2011		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	521	10.65	0.55	962	7.89	0.76
Non-Indexed	1,592	2.21	0.35	364	8.17	0.30
Total	2,113	4.29	0.90	1,326	7.97	1.06

Net position of trading bonds and debt instruments	26,409	0.50	(1.35)	16,284	(0.09)	0.16

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The Bank holds a significant amount of foreign triple-A credit-rated government bills in its liquidity portfolio but the Bank's policy is to only invest in bills whith a credit rating of Aa3 or higher according to Moody's long-term issuer rating. These bills are held for cash management purposes and can be liquidated with a short notice. Duration ranges up to three months and the sensitivity measured in BPV was ISK -0.4 million at the end of 2012 (2011: ISK -0.3 million).

Foreign government bills	31.12.2012		31.12.2011	
Country	Market value	BPV	Market value	BPV
Denmark	-	-	3,205	(0.08)
Finland	-	-	794	(0.00)
France	5,094	(0.04)	1,588	(0.01)
Germany	2,547	(0.05)	-	-
Netherlands	7,641	(0.13)	3,179	(0.05)
Norway	1,149	(0.02)	2,033	(0.06)
USA	10,298	(0.17)	5,522	(0.13)
Total	26,729	(0.41)	16,321	(0.33)

73. Sensitivity analysis for interest rate risk in the trading portfolios

For sensitivity analysis in the trading portfolio the Bank applies a 100 bps shift in ISK, non-indexed and indexed interest rates. Shifts in rates in other currencies are scaled down in accordance with lower volatility. The following table demonstrates the sensitivity of the Bank's equity and income statement to a reasonable change in interest rates, all other risk factors held constant.

Sensitivity analysis for trading bonds and debt instruments		31.12.2012		31.12.2011	
		Profit or (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	120	(120)	(41)	41
ISK, non-indexed	100	(27)	27	(7)	7
CHF	40	-	-	-	-
EUR	20	4	(4)	1	(1)
GBP	40	-	-	-	-
JPY	20	-	-	-	-
USD	40	7	(7)	5	(5)
Other total	40	1	(1)	6	(6)
Total		105	(105)	(36)	36

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74. Interest rate risk in the non-trading portfolio

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

The Bank holds a government bond designated at fair value amounting to ISK 30.9 billion (2011: ISK 30.8 billion). The bond pays floating rates, which change monthly, and carries relatively low interest rate risk.

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

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

Non-trading portfolio interest rate adjustment periods 31 December 2012

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	83,493	-	-	-	-	-	83,493
Bonds and debt instruments	33,424	795	403	382	575	58	35,637
Loans to credit institutions	53,891	151	-	-	-	-	54,042
Loans to customers	402,204	55,795	29,166	56,382	1,361	14,686	559,594
Total assets	573,012	56,741	29,569	56,764	1,936	14,744	732,766
Off-balance sheet items	57,521	9,820	9,395	505	113	-	77,354
Liabilities							
Short positions	-	3,226	1,140	850	-	-	5,216
Deposits from Central Bank	54	-	-	-	-	-	54
Deposits from credit institutions	37,837	381	-	-	-	-	38,218
Deposits from customers	459,233	1,657	888	2,743	6,635	-	471,156
Debt issued and other borrowed funds	7,420	-	-	6,018	48,193	4,940	66,571
Subordinated loans	23,450	-	-	-	-	-	23,450
Total liabilities	527,994	5,264	2,028	9,611	54,828	4,940	604,665
Off-balance sheet items	62,374	10,150	9,657	499	-	-	82,680
Net interest gap on 31 December 2012	40,165	51,147	27,279	47,159	(52,779)	9,804	122,775

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Non-trading portfolio interest rate adjustment periods 31 December 2011

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	56,016	-	-	-	-	-	56,016
Bonds and debt instruments	32,218	1,153	1,069	370	1,398	4,458	40,666
Loans to credit institutions	43,551	104	-	-	-	-	43,655
Loans to customers	420,171	27,158	35,739	63,895	1,914	15,517	564,394
Total assets	551,956	28,415	36,808	64,265	3,312	19,975	704,731
Off-balance sheet items	59,201	-	10,007	3,115	113	-	72,436
Liabilities							
Short positions	-	3,567	1,815	477	-	-	5,859
Deposits from Central Bank	73	-	-	-	-	-	73
Deposits from credit institutions	61,711	1,061	-	-	-	-	62,772
Deposits from customers	456,329	3,383	759	807	1,665	-	462,943
Debt issued and other borrowed funds	7,221	-	-	6,679	49,133	188	63,221
Subordinated loans	21,937	-	-	-	-	-	21,937
Total liabilities	547,271	8,011	2,574	7,963	50,798	188	616,805
Off-balance sheet items	62,484	-	9,862	3,070	-	-	75,416
Net interest gap on 31 December 2011	1,402	20,404	34,379	56,347	(47,373)	19,787	84,946

75. Sensitivity analysis for interest rate risk for non-trading portfolios

For sensitivity analysis in the banking book a 100 bps shift is applied for non-indexed ISK interest rates. Shifts in other currencies are chosen using the same scaling factors as in the trading portfolio. CPI-linked ISK rate shifts are also scaled down to reflect significantly stronger mean reversion than for non-indexed rates. The table shows how applied shifts would affect the fair value of the Bank's banking book.

Sensitivity analysis for non-trading bonds and debt instruments		31.12.2012		31.12.2011	
		Profit or (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	40	228	(228)	935	(935)
ISK, non-indexed	100	301	(301)	487	(487)
CHF	40	(2)	2	(5)	5
EUR	20	(3)	3	(3)	3
GBP	40	1	(1)	1	(1)
JPY	20	4	(4)	3	(3)
USD	40	4	(4)	8	(8)
Other	40	(1)	1	(1)	1
Total		532	(532)	1,425	(1,425)

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Currency risk

76. 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 mismatch in the currency composition of assets or liabilities.

The analysis of the Bank's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements. Most of the net non-adjusted currency imbalance is due to loans with a non-ISK contractual currency to customers with ISK income. The Bank has determined that these loans have a recovery value that is limited in ISK terms. To reflect the ISK based recovery value of these loans the Bank has impaired fully the foreign exchange gains on these assets. Should there be an appreciation of the ISK there will be a corresponding reversal of the impairment charge. This is in accordance with IFRS accounting standards. The Bank's regulators allow for an adjustment of the contractual currency imbalance to reflect the recovery of foreign currency denominated loans to customers with ISK income. The tables below summarise the Bank's exposure to currency risk at 31 December 2012 and 31 December 2011, based on contractual currencies, off-balance sheet items along with the currency adjustment, but excluding assets categorised as held-for-sale.

Currency analysis 31 December 2012

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank	355	187	101	30	11	248	932
Bonds and debt instruments	15,283	10,686	-	-	-	1,149	27,118
Shares and equity instruments	491	255	16	2	-	-	764
Loans to credit institutions	13,721	17,758	683	2,166	2,836	9,235	46,399
Loans to customers	64,979	18,377	5,453	12,421	14,001	1,946	117,177
Investments in associates	21	348	-	-	-	-	369
Other assets	358	1,096	138	-	4	30	1,626
Total assets	95,208	48,707	6,391	14,619	16,852	12,608	194,385
Liabilities							
Deposits from credit institutions	44	5	-	-	-	-	49
Deposits from customers	28,752	26,484	3,960	1,025	720	5,937	66,878
Debt issued and other borrowed funds	-	-	-	-	-	128	128
Subordinated loans	23,450	-	-	-	-	-	23,450
Other liabilities	1,521	4,088	669	1	16	166	6,461
Total liabilities	53,767	30,577	4,629	1,026	736	6,231	96,966
Non-adjusted foreign exchange on-balance sheet imbalance	41,441	18,130	1,762	13,593	16,116	6,377	97,419
Adjustment of currency imbalance for FX/ISK loans	4,670	703	139	3,831	3,193	217	12,753
Adjusted imbalance	36,771	17,427	1,623	9,762	12,923	6,160	84,666
Off-balance sheet items							
Off-balance sheet assets	3,862	12,786	445	-	1,800	464	19,357
Off-balance sheet liabilities	24,610	26,826	722	9,818	13,394	795	76,165
Net off-balance sheet items	(20,748)	(14,040)	(277)	(9,818)	(11,594)	(331)	(56,808)
Net currency imbalance on 31 December 2012	16,023	3,387	1,346	(56)	1,329	5,829	27,858

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Currency analysis 31 December 2011

Assets	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank	491	124	63	36	10	226	950
Bonds and debt instruments	5,919	5,890	-	-	-	5,238	17,047
Shares and equity instruments	630	122	213	-	-	-	965
Loans to credit institutions	18,866	10,355	1,492	1,236	382	5,220	37,551
Loans to customers	60,941	18,176	4,813	22,681	25,082	2,473	134,166
Investments in associates	20	433	-	-	-	-	453
Other assets	-	-	-	-	-	-	-
Total assets	86,867	35,100	6,581	23,953	25,474	13,157	191,132
Liabilities							
Deposits from credit institutions	2,511	380	135	11	2	95	3,134
Deposits from customers	21,307	19,451	4,557	725	536	8,547	55,123
Debt issued and other borrowed funds	-	-	-	-	-	14	14
Subordinated loans	21,937	-	-	-	-	-	21,937
Other liabilities	-	-	-	-	-	-	-
Total liabilities	45,755	19,831	4,692	736	538	8,656	80,208
Non-adjusted foreign exchange on-balance sheet imbalance	41,112	15,269	1,889	23,217	24,936	4,501	110,924
Adjustment of currency imbalance for FX/ISK loans	16,007	3,075	806	12,638	13,210	912	46,648
Adjusted imbalance	25,105	12,194	1,083	10,579	11,726	3,589	64,276
Off-balance sheet items							
Off-balance sheet assets	4,265	17,238	38	239	2,459	76	24,315
Off-balance sheet liabilities	21,176	25,427	294	11,106	15,011	1,891	74,905
Net off-balance sheet items	(16,911)	(8,189)	(256)	(10,867)	(12,552)	(1,815)	(50,590)
Net currency imbalance on 31 December 2011	8,194	4,005	827	(288)	(826)	1,774	13,686

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77. Sensitivity analysis towards currency risk

The table below shows how the adjusted imbalance is affected by either depreciation or appreciation of each currency assuming other risk factors being held constant. The shift number is the 99% percentile of a 10-day return distribution for each currency for the previous 365 days. The adverse movement of each currency is applied for the impact of the shift and demonstrates how equity and income statement would be affected by the shifts.

Sensitivity towards currency risk 31 December 2012

Currency (shift)	**Shift Effect**
EUR (4%)	(641)
USD (5%)	(169)
CHF (4%)	(2)
GBP (4%)	(54)
JPY (5%)	(66)
Other (4%)	(233)
Total	(1,165)

Sensitivity towards currency risk 31 December 2011

Currency (shift)	**Shift Effect**
EUR (2%)	(164)
USD (3%)	(120)
CHF (9%)	(26)
GBP (2%)	(17)
JPY (5%)	(41)
Other (4%)	(71)
Total	(439)

Shares and equity instruments

78. The Bank's equity exposure in the trading book arises from flow trading, mainly in shares denominated in ISK. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the equity risk and concentration risk in the Bank's portfolio. Shares and equity instruments in the banking book are designated at fair value through profit or loss or are classified as held-for-sale.

79. Sensitivity analysis for shares and equity instruments

The following table demonstrates how reasonable shifts in the prices of trading and banking book would affect the equity and net financial income. Shifts applied for the trading and banking book are 20% and 40% respectively.

Sensitivity analysis for equities		31.12.2012		31.12.2011	
		Profit or loss			
Portfolio (ISK million)	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading	20%	(333)	333	(79)	79
Non-trading	40%	(4,341)	4,341	(5,117)	5,117
Total		(4,674)	4,674	(5,196)	5,196

Derivatives

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

Inflation risk

81. The Bank is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit or loss. On 31 December 2012 the CPI gap amounted to ISK 1.3 billion (31 December 2011: ISK 22.2 billion). Thus, a 1% increase in the index would have a positive impact on the profit or loss account to the amount of ISK 13 million in profit and a 1% decrease would result in a corresponding loss, other risk factors held constant.

Notes to the Consolidated Financial Statements

Capital management

82. Risk exposure and capital base

The Icelandic capital adequacy rules are based on the EU capital requirements directives (CRD). The capital adequacy rules require an absolute minimum capital level of 8% of risk weighted assets as calculated under Pillar 1 of the Basel II rules.

Capital requirements in excess of the legal minimum of 8% of risk weighted assets are determined under Pillar 2 which sets forth a framework for the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) conducted by the FME. The Banks capital ratio was 25.5% at the end of 2012. Based on the results from the Bank's ICAAP and taking into account the results from the SREP, the Bank's capital ratio is in excess of both internal and regulatory requirements. Further information about the capital requirements and adequacy can be seen in Íslandsbanki's Risk Report which is published concurrent to the Annual Report.

The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach. Market risk exposure for currency risk is based on the adjusted currency imbalance described in Note 76.

The table below shows the capital base, risk weighted assets and capital ratios of the Bank at 31 December 2012 and 31 December 2011.

	2012	2011
Tier 1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,834	2,661
Retained earnings	78,571	55,133
Non-controlling interests	1,255	909
Tax assets	(864)	(2,629)
Intangible assets	(261)	(544)
Other regulatory adjustments	(321)	-
Total Tier 1 capital	146,214	120,530
Tier 2 capital		
Other regulatory adjustments	(322)	-
Qualifying subordinated liabilities	23,450	21,937
Total regulatory capital	169,342	142,467
Risk weighted assets		
- due to credit risk	549,535	532,301
- due to market risk:	33,940	16,695
Market risk, trading book	6,006	1,895
Currency risk FX	27,934	14,800
- due to operational risk	81,214	80,423
Total risk weighted assets	664,689	629,419
Capital ratios		
Tier 1 ratio	22.0%	19.1%
Total capital ratio	25.5%	22.6%

Article 86 of the act on Financial Undertakings (161/2002) details the measures taken in the case of insufficient own funds of a financial undertaking. If the board or managing directors of a financial undertaking have reason to expect that its own funds will be less than the minimum required by law, they must immediately notify the Financial Supervisory Authority (FME) thereof. The FME may grant the financial undertaking concerned a time limit of up to six months to increase its own funds to the minimum provided. If the remedies are not satisfactory in the opinion of the FME, or if the time limit provided for expires, the operating licence of the financial undertaking shall be revoked.

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Notes to the Consolidated Financial Statements

Operational risk

83. The Bank has adopted the definition of operational risk from the Directive 2006/48/EC of the European Parliament and of the Council, where operational risk is defined "as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events". The Bank's definition of operational risk includes legal risk, compliance risk, and reputational risk.

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank and its subsidiaries. The policy outlines a framework for operational risk management in the Bank. The operational risk management framework is described in further detail in several subdocuments, such as the Business Continuity Management Framework, the Security Policy, and the Crisis Communication Policy, all of which are approved by the Executive Board.

According to the Operational Risk Management Policy, the Executive Board is responsible for the operational risk management framework, and the Risk Monitoring Unit within Risk Management and Credit Control is responsible for the implementation of the operational risk framework throughout the Bank.

The Bank uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for Pillar 1 operational risks, in accordance with FME regulations 215/2007 on capital management.