# CONSOLIDATED FINANCIAL STATEMENTS

## 2015

Íslandsbanki hf. | Kirkjusandi | 155 Reykjavík | Iceland | Reg. no. 491008-0160

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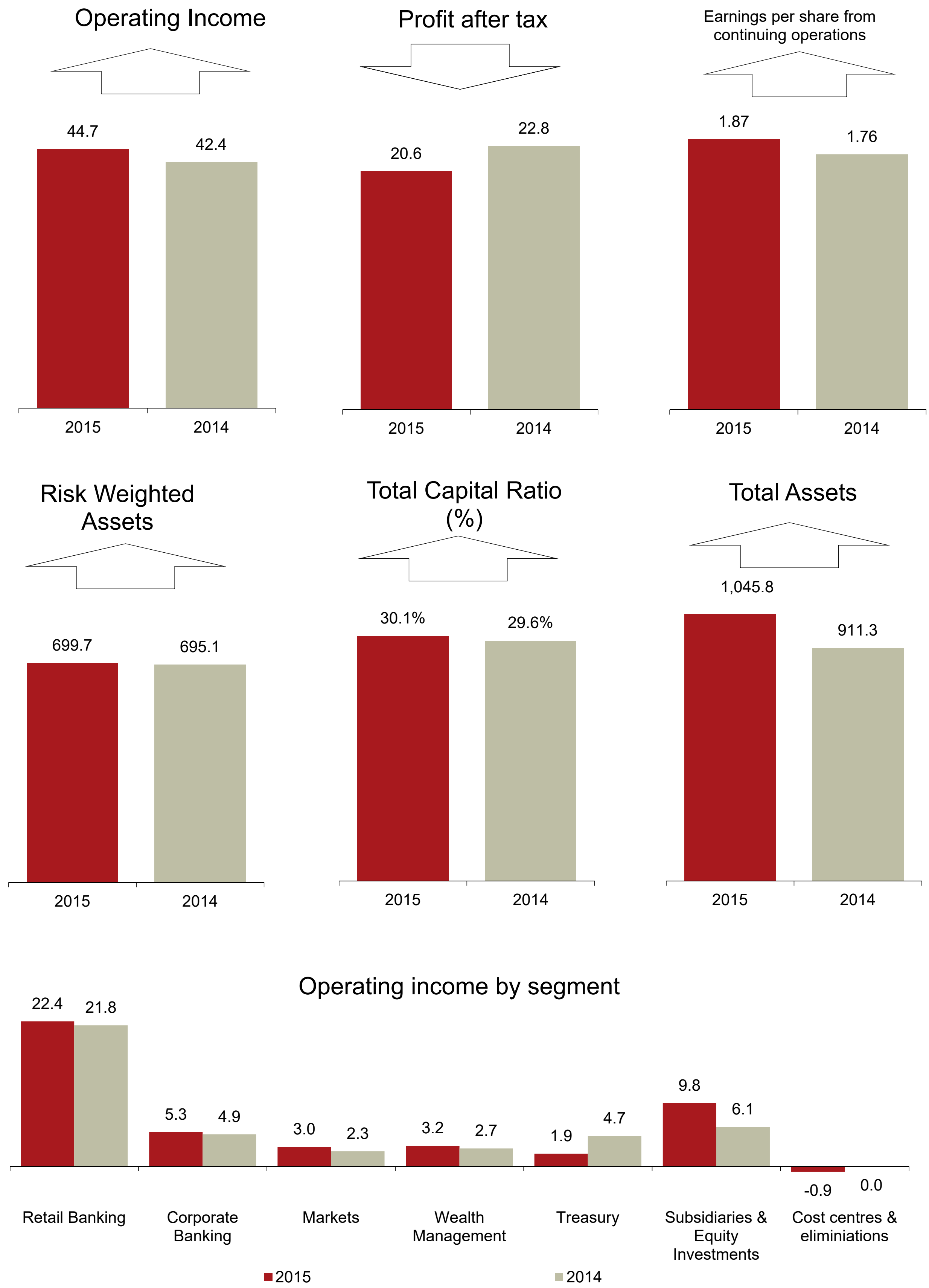
# Financial Highlights 2015

Amounts on this page are in ISK billion



# Directors' Report

The audited consolidated financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") for the financial year 2015 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Group".

## Operations in 2015

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland and overseas. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share.

The Bank, which traces its roots back to 1875, builds on a solid heritage of lending to industry in Iceland. It has developed specific expertise in lending to the tourism, seafood, municipal, and energy sectors. With its focused approach in these fields, Íslandsbanki offers valuable services to industry players and investors.

The Bank is divided into six business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury, and Subsidiaries & Equity Investments. The Bank operates a diverse and efficient branch network, with 17 branches strategically located in the Reykjavík metropolitan area and in larger towns across the country. At the end of 2015, the Group employed 1,184 full-time members of staff, including 919 within the Bank itself.

The profit from the Group's operations for the financial year 2015 amounted to ISK 20,578 million, which corresponds to a 10.8% annualised return on equity. The Group's total equity amounted to ISK 202,227 million and total assets were ISK 1,045,769 million as of year-end 2015 and return on assets 2.1%. The Group's total capital ratio, calculated according to the Act on Financial Undertakings, was 30.1%, well above the current short- to medium-term target of 23%. The year-end liquidity position was strong and well above the regulatory minimum.

In line with the Bank's published dividend policy, the Board of Directors proposes that up to 50% of the net profit for the financial year 2015 be paid in dividends to shareholders, with the balance retained for the Bank's future development. The Board may convene a special shareholders' meeting later in the year to propose payment of an additional dividend if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements.

The Icelandic economy performed strongly in 2015. Inflation was 2.0% over the year, and the unemployment rate was at 2.8% at the year-end. The ratio of investment to GDP continued to rise, and the tourism sector continued to flourish. The Icelandic króna remained fairly stable and positive currency flows, particularly from tourism, allowed the Central Bank to accumulate ISK 313 billion in foreign reserves funded with ISK liabilities by year-end 2015.

The Bank's loan portfolio grew broadly in line with GDP growth in 2015. At the same time, customer deposits grew by 12% and borrowings by ISK 53 billion, as the Bank successfully issued covered bonds in Iceland and unsecured notes abroad under its GMTN programme.

In April 2015, Fitch Ratings assigned the Bank an investment-grade rating of BBB-/F3 with a stable outlook. Íslandsbanki was the first Icelandic bank to be assigned an investment-grade rating since 2008. In July 2015, Standard & Poor's upgraded the Bank's long-term and short-term ratings to BBB-/A-3 with a stable outlook.

The Bank has continued to streamline its branch network. In 2015 two branches were closed and a new one opened. The changes to the branch network are closely linked to the surge in online and mobile banking, reflected in a 58% rise in use of Íslandsbanki's mobile app and a 10% increase in use of its online banking platform.

## Outlook

The economic environment in Iceland is expected to remain buoyant in the near to medium term. Growth is expected to remain strong and public and private investment levels to increase. Government and household finances are likely to improve, and debt levels could decline further.

On 8 June 2015, the Icelandic Ministry of Finance and Economic Affairs introduced its capital account liberalisation strategy, designed to lift the capital controls that have been in place in Iceland since 2008. After the strategy was announced, the financial undertakings in winding-up proceedings sought composition agreements with their creditors, and implementation of the agreements is expected to be largely in place by the end of Q1/2016. As a result, conditions seem quite favourable for removal of capital controls in the near future.

Glitnir hf.'s composition agreement provided for the transfer to the Icelandic Government of a 95% stake in Íslandsbanki as Glitnir's stability contribution. As a result, the Bank is expected to be fully government owned by the end of Q1 2016. The Icelandic Minister of Finance has stated that it is not the Government's intention to retain ownership of the Bank for the long term and that plans for its sale should be put in place in the near future.

In January 2016, Standard & Poor's upgraded the Republic of Iceland's sovereign credit rating to BBB+, citing further progress towards capital account liberalisation and declining debt levels. Shortly thereafter, Íslandsbanki's ratings were affirmed at BBB- with a positive outlook.

The strong economic environment suggests that the outlook for the Bank's core operations is favourable. Lending is expected to grow at a moderate pace, and there are good opportunities to strengthen fee income further. Deposits will remain the largest source of funding, and the Bank continues to see improvements in the terms on its long-term debt issuance.

# Directors' Report

## 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 57-83 to the financial statements and in the unaudited Pillar 3 Report.

## Corporate governance

Sound governance practices are essential for companies' long-term performance as they improve their work habits, transparency, and accountability, thereby protecting and furthering the interests of shareholders and other stakeholders. Íslandsbanki's Board of Directors is committed to a governance framework that reflects the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as "Exemplary in Corporate Governance" in March 2014 by the Centre of Corporate Governance at the University of Iceland's Institute for Business Research. The award was made following a comprehensive review of the practices of the Bank's Board, Board subcommittees, and management. The recognition was renewed in March 2015.

Íslandsbanki's management structure consists of the CEO and the Board of Directors, comprising seven non-executive directors and three alternates. The Board oversees the Bank's affairs and is responsible for setting the Bank's general strategy as well as directing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities comply at all times with applicable regulatory instruments and good business practices. The Board has appointed four Board subcommittees comprising members of the Board: Board Audit Committee; Board Risk Committee; Board Strategy Committee; and Board Corporate Governance, Compensation, and Human Resource Committee.

Furthermore, the Board monitors the execution of its policies, the sound control of accounting and financial management, and the effectiveness of group internal audit, compliance, and risk management. Further information on Íslandsbanki's risk management structure and risk profile can be found in the Bank's unaudited annual Pillar 3 Report.

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and the resolutions of the Board of Directors. Moreover, the CEO is required to ensure that the Bank's operations are at all times consistent with its Articles of Association and applicable legislation. The CEO appoints a nine-member Executive Board, of which the CEO is a member. The Executive Board's role is to maintain an overview of the Bank's operations and coordinate key aspects of its activities that are not supervised by other management committees.

Group Internal Audit is independent of other departments. The Chief Audit Executive is appointed by the Board and is responsible for internal audit at the group level and for monitoring the adequacy of the Bank's risk management, supervision, and governance processes.

The Compliance Officer is appointed by the CEO, subject to confirmation by the Board, and is responsible for monitoring and assessing on a regular basis whether the Bank's operations regarding securities transactions and measures to combat anti-money laundering and terrorist financing are in compliance with applicable law.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to supervision by the Financial Supervisory Authority (FME), as well as other applicable laws and regulations, including those imposed by the FME and Nasdaq Iceland. The applicable laws include the Act on Financial Undertakings, no. 161/2002; the Act on Securities Transactions, no. 108/2007; the Act on Public Limited Companies, no. 2/1995; and the Act on Competition, no. 44/2005 available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland, and SA-Business Iceland, available at www.corporategovernance.is. The Bank's practices are in compliance with the guidelines except for certain items in Articles 1.5, 2.9 and 5.1.2 of the guidelines.

Further details on Íslandsbanki's governance framework and associated practices, as well as a discussion regarding any deviation from the Corporate Governance Guidelines, can be found in the Bank's Corporate Governance Statement, enclosed in an unaudited appendix to the consolidated financial statements.

## Corporate social responsibility

The Bank has issued a Global Compact Report that summarises key areas of its Corporate Social Responsibility ("CSR") policy, which are business, human capital, community, and environment. The United Nation's Global Compact strategic policy initiative provides the parameters within the Bank's policy. A new CSR policy was implemented in the beginning of 2015, with focus placed on nine priority projects for the year, including setting a policy for responsible lending. The Bank's aim is to be a forward-looking and reliable banking institution that is responsible in all of its actions and plays a proactive role in enhancing the community and the environment in which it operates.

# Directors' Report

## Ownership

The Bank had two shareholders at year-end 2015: ISB Holding ehf., which held 95% of the Bank's share capital, and the Icelandic Treasury which held 5% through Icelandic State Financial Investments (ISFI – Bankasýsla ríkisins).

At the end of 2015, the Bank had seven Board members, four male and three female. One Board member was appointed by ISFI and the remaining six by ISB Holding ehf.

The Bank welcomed two new Board members during the reporting period. Eva Cederbalk joined the Board in March, and in September Thóranna Jónsdóttir resigned and was replaced by Gunnar Fjalar Helgason.

## Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2015 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable, to the extent that they are not inconsistent with the requirements of the IFRS as adopted by the EU.

The Board of Directors draws special attention to the financial environment in Iceland, where capital controls are still in place. The Board also notes that the Bank maintains a strong capital and liquidity position and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 2 and 55 to the financial statements for the principal risks and uncertainties currently faced by the Group.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2015 and its financial position as of 31 December 2015. It also describes the principal risks and uncertainties currently faced by the Group.

The Board of Directors and the CEO have discussed the 2015 consolidated financial statements of Íslandsbanki and confirmed them with their signatures today.

Reykjavík, 22 February 2016

**Board of Directors:**

Fridrik Sophusson, Chairman
Marianne Økland, Vice-Chairman
Árni Tómasson
Eva Cederbalk
Gunnar Fjalar Helgason
Helga Valfells
Neil Graeme Brown

**Chief Executive Officer:**
Birna Einarsdóttir

# Independent Auditor's Report

## To the Board of Directors and shareholders of Íslandsbanki hf.

We have audited the accompanying consolidated financial statements of Íslandsbanki hf. and its subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2015 and the consolidated income statement, consolidated statement of profit and loss and other comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended and a summary of significant accounting polices and other explanatory information.

## Management's and the Board of Directors responsibility for the consolidated financial statement

Management and the Board of Directors are responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institution, where applicable. Management and the Board of Directors are responsible for the internal control necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

## Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the 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

It is our opinion, that the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December 2015, of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institution, where applicable.

## Confirmation of endorsement and statement by the Board of Directors and CEO

Pursuant to requirements of Paragraph 2 article 104 of the Icelandic financial statements no. 3/2006, we confirm to the best of our knowledge that the accompanying endorsement and statement by Board of Directors and the CEO includes all information required by the Icelandic financial statement act that is not disclosed elsewhere in the consolidated financial statements.

Reykjavík, 22 February 2016

**Ernst & Young ehf.**

Margrét Pétursdóttir
State Authorised Public Accountant

# Consolidated Income Statement for the year 2015

| | Notes | 2015 | 2014 |
|---|---|---|---|
| Interest income | 11 | 53,414 | 50,816 |
| Interest expense | 11 | ( 25,404) | ( 23,711) |
| **Net interest income** | | 28,010 | 27,105 |
| Fee and commission income | 12 | 20,737 | 17,984 |
| Fee and commission expense | 12 | ( 7,567) | ( 6,501) |
| **Net fee and commission income** | | 13,170 | 11,483 |
| Net financial income | 13-15 | 3,881 | 1,568 |
| Net foreign exchange (loss) gain | 16 | ( 1,490) | 165 |
| Other operating income | 17 | 1,102 | 2,122 |
| **Other net operating income** | | 3,493 | 3,855 |
| **Total operating income** | | 44,673 | 42,443 |
| Salaries and related expenses | 18-20 | ( 13,891) | ( 13,307) |
| Other operating expenses | 21 | ( 9,869) | ( 9,594) |
| Contribution to the Depositors' and Investors' Guarantee Fund | | ( 1,067) | ( 1,055) |
| Bank tax | 86.26 | ( 2,878) | ( 2,444) |
| **Total operating expenses** | | ( 27,705) | ( 26,400) |
| **Profit before net loan impairment** | | 16,968 | 16,043 |
| Net loan impairment | 23 | 8,135 | 8,810 |
| **Profit before tax** | | 25,103 | 24,853 |
| Income tax expense | 25 | ( 5,851) | ( 6,239) |
| **Profit for the year from continuing operations** | | 19,252 | 18,614 |
| Profit from discontinued operations, net of income tax | 24 | 1,326 | 4,136 |
| **Profit for the year** | | 20,578 | 22,750 |

| | Notes | 2015 | 2014 |
|---|---|---|---|
| **Profit attributable to:** | | | |
| Equity holders of Íslandsbanki hf. | | 20,000 | 21,740 |
| Non-controlling interests | | 578 | 1,010 |
| **Profit for the year** | | 20,578 | 22,750 |
| **Earnings per share from continuing operations** | | | |
| Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf. | 26 | 1.87 | 1.76 |

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

# Consolidated Statement of Profit or Loss and other Comprehensive Income for the year 2015

| | Notes | 2015 | 2014 |
|---|---|---|---|
| Profit for the year | | 20,578 | 22,750 |
| Other comprehensive income | | | |
| Items that are or may be reclassified to profit or loss | | | |
| Foreign currency translation differences for foreign operations | 52 | 9 | 64 |
| Fair value reserve (available for sale financial assets): | | | |
| Net change in fair value, tax exempt | | 5,445 | - |
| Other comprehensive income for the year, net of tax | | 5,454 | 64 |
| Total comprehensive income for the year | | 26,032 | 22,814 |

| | 2015 | 2014 |
|---|---|---|
| Total comprehensive income attributable to: | | |
| Equity holders of Íslandsbanki hf. | 23,467 | 21,804 |
| Non-controlling interests | 2,565 | 1,010 |
| Total comprehensive income for the year | 26,032 | 22,814 |

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

# Consolidated Statement of Financial Position as at 31 December 2015

| | Notes | 31.12.2015 | 31.12.2014 |
|---|---|---|---|
| **Assets** | | | |
| Cash and balances with Central Bank | 27 | 216,760 | 103,389 |
| Bonds and debt instruments | 7 | 78,606 | 87,347 |
| Shares and equity instruments | 7 | 18,320 | 10,531 |
| Derivatives | 28 | 1,981 | 1,810 |
| Loans to credit institutions | 29 | 35,534 | 35,072 |
| Loans to customers | 30-31 | 665,711 | 634,799 |
| Investments in associates | 32-33 | 716 | 570 |
| Property and equipment | 37 | 7,344 | 7,402 |
| Intangible assets | 38 | 1,331 | 619 |
| Other assets | 39 | 6,674 | 8,140 |
| Non-current assets and disposal groups held for sale | 40 | 12,792 | 21,649 |
| **Total Assets** | | 1,045,769 | 911,328 |
| **Liabilities** | | | |
| Deposits from Central Bank and credit institutions | 41 | 25,631 | 25,796 |
| Deposits from customers | 42-43 | 593,245 | 529,447 |
| Derivative instruments and short positions | 28 | 6,981 | 3,963 |
| Debt issued and other borrowed funds | 45 | 150,308 | 96,889 |
| Subordinated loans | 46 | 19,517 | 21,306 |
| Tax liabilities | 47-49 | 8,358 | 8,388 |
| Other liabilities | 50 | 36,677 | 37,262 |
| Non-current liabilities and disposal groups held for sale | 40 | 2,825 | 2,790 |
| **Total Liabilities** | | 843,542 | 725,841 |
| **Equity** | | | |
| Share capital | 51 | 10,000 | 10,000 |
| Share premium | 51 | 55,000 | 55,000 |
| Other reserves | 52 | 6,002 | 2,535 |
| Retained earnings | | 127,288 | 116,288 |
| **Total equity attributable to the equity holders of Íslandsbanki hf.** | | 198,290 | 183,823 |
| Non-controlling interests | | 3,937 | 1,664 |
| **Total Equity** | | 202,227 | 185,487 |
| **Total Liabilities and Equity** | | 1,045,769 | 911,328 |

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

# Consolidated Statement of Changes in Equity for the year 2015

| | Notes | Share capital | Share premium | Other reserves | Retained earnings | Total | Non-controlling interests | Total equity |
|---|---|---|---|---|---|---|---|---|
| | | Attributable to the equity holders of Íslandsbanki hf. | | | | | | |
| **Equity as at 1.1.2014** | | 10,000 | 55,000 | 2,471 | 98,548 | 166,019 | 1,299 | 167,318 |
| Translation differences for foreign operations | 52 | | | 64 | | 64 | | 64 |
| Net change in fair value of financial assets available for sale | | | | - | - | - | | - |
| Net Income recognised directly in equity | | - | - | 64 | - | 64 | - | 64 |
| Profit for the year | | | | | 21,740 | 21,740 | 1,010 | 22,750 |
| Total comprehensive income for the year | | - | - | 64 | 21,740 | 21,804 | 1,010 | 22,814 |
| Dividends paid | | | | | (4,000) | (4,000) | - | (4,000) |
| Change in non-controlling interests | | | | | | - | (645) | (645) |
| **Equity as at 31.12.2014** | 51 | 10,000 | 55,000 | 2,535 | 116,288 | 183,823 | 1,664 | 185,487 |
| | | | | | | | | |
| **Equity as at 1.1.2015** | | 10,000 | 55,000 | 2,535 | 116,288 | 183,823 | 1,664 | 185,487 |
| Translation differences for foreign operations | 52 | | | 9 | | 9 | | 9 |
| Net change in fair value of financial assets available for sale | | | | 3,458 | | 3,458 | 1,987 | 5,445 |
| Net income recognised directly in equity | | - | - | 3,467 | - | 3,467 | 1,987 | 5,454 |
| Profit for the year | | | | | 20,000 | 20,000 | 578 | 20,578 |
| Total comprehensive income for the year | | - | - | 3,467 | 20,000 | 23,467 | 2,565 | 26,032 |
| Dividends paid | | | | | (9,000) | (9,000) | (292) | (9,292) |
| Change in non-controlling interests | | | | | | - | | - |
| **Equity as at 31.12.2015** | 51 | 10,000 | 55,000 | 6,002 | 127,288 | 198,290 | 3,937 | 202,227 |

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

# Consolidated Statement of Cash Flows for the year 2015

| | Notes | 2015 | 2014 |
|---|---|---|---|
| **Cash flows from operating activities:** | | | |
| Profit for the year | | 20,578 | 22,750 |
| **Adjustments to reconcile profit for the year to cash flows provided by (used in) operating activities:** | | | |
| Non-cash items included in profit for the year and other adjustments | | 2,860 | ( 1,710) |
| Changes in operating assets and liabilities | | 58,277 | ( 32,812) |
| Dividends received | | 681 | 185 |
| Income tax and bank tax paid | | ( 8,386) | ( 10,685) |
| **Net cash provided by (used in) operating activities** | | 74,010 | ( 22,272) |
| **Cash flows from investing activities:** | | | |
| Net investment in subsidiaries and associated companies | | - | 896 |
| Investments in associated companies | | ( 33) | ( 62) |
| Proceeds from sale of property and equipment | | 71 | 1,543 |
| Purchase of property and equipment | 37 | ( 743) | ( 758) |
| Purchase of intangible assets | 38 | ( 848) | ( 464) |
| **Net cash (used in) provided by investing activities** | | ( 1,553) | 1,155 |
| **Cash flows from financing activities:** | | | |
| Proceeds from borrowings | | 76,395 | 39,590 |
| Repayment of borrowings | | ( 24,318) | ( 34,908) |
| Dividends paid | | (9,000) | ( 4,000) |
| **Net cash provided by financing activities** | | 43,077 | 682 |
| Net increase (decrease) in cash and cash equivalents | | 115,534 | ( 20,435) |
| Effects of foreign exchange rate changes | | ( 127) | 22 |
| Cash and cash equivalents at the beginning of the year | | 118,020 | 138,433 |
| **Cash and cash equivalents at year end** | | 233,427 | 118,020 |

| **Reconciliation of cash and cash equivalents:** | | | |
|---|---|---|---|
| Cash on hand | 27 | 2,784 | 2,256 |
| Cash balances with Central Bank, certificates of deposit and term deposit | 27 | 198,997 | 91,581 |
| Bank accounts | 29 | 31,646 | 24,183 |
| **Cash and cash equivalents at year end** | | 233,427 | 118,020 |

The Group has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year. 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 2015 was ISK 55,349 million (2014: ISK 52,000 million) and interest paid in 2015 was ISK 24,404 million (2014: ISK 25,541 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

# Consolidated Statement of Cash Flows for the year 2015

| Non-cash items included in profit for the year and other adjustments: | 2015 | 2014 |
|---|---|---|
| Depreciation and impairment | 672 | 820 |
| Amortisation of intangible assets | 136 | 144 |
| Share of (gain) loss of associates | ( 113) | 159 |
| Accrued interest and foreign exchange gain on debt issued | 4,258 | 3,320 |
| Impairment on loans | 3,184 | 1,856 |
| Reversal of impairment previously recorded against loans | ( 11,319) | ( 10,666) |
| Foreign exchange loss (gain) | 1,490 | ( 165) |
| Net loss (gain) on sale of property and equipment | 57 | ( 234) |
| Unrealised fair value gains through profit and loss | ( 2,908) | ( 1,491) |
| Net profit on non-current assets classified as held for sale | ( 1,326) | ( 4,136) |
| Bank tax | 2,878 | 2,444 |
| Income tax | 5,851 | 6,239 |
| **Non-cash items included in profit for the year and other adjustments** | 2,860 | ( 1,710) |

| Changes in operating assets and liabilities: | 2015 | 2014 |
|---|---|---|
| Mandatory reserve with Central Bank | ( 5,427) | ( 5,949) |
| Loans and receivables to credit institutions | 7,140 | 4,799 |
| Loans and receivables to customers | ( 29,172) | ( 71,126) |
| Trading assets | 4,309 | ( 13,492) |
| Other operating assets | 1,049 | 4,294 |
| Non-current assets and liabilities held for sale | 9,796 | 24,045 |
| Deposits with credit institutions and Central Bank | ( 166) | ( 3,941) |
| Deposits from customers | 68,503 | 37,918 |
| Trading financial liabilities | 3,387 | ( 8,777) |
| Derivatives | ( 540) | 597 |
| Other operating liabilities | ( 602) | ( 1,180) |
| **Changes in operating assets and liabilities** | 58,277 | ( 32,812) |

### Non-cash transactions 2015

During 2015 the Group entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Group recognised fair value changes of ISK 5.4 billion in 2015 which had no cash effect on the Group.

### Non-cash transactions 2014

During 2014 the Group entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Group changed a loan to a subsidiary for the amount of ISK 530 million to equity holding. This transaction had no cash effect on the Group.

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

# Notes to the Consolidated Financial Statements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# Notes to the Consolidated Financial Statements

## 1. Corporate information

Íslandsbanki hf. the parent company was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Kirkjusandur 2, 155 Reykjavík, Iceland.

The consolidated financial statements for the year ended 31 December 2015 were prepared on a going concern basis and comprise Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group". Comparative information refers to the year ended 31 December 2014.

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 Group provides a wide range of financial services such as retail banking, corporate banking, brokerage services, wealth management and asset financing. The Group operates mainly in the Icelandic market.

## 2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union, the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions, where applicable.

Information about the Group's accounting policies are provided in Notes 84-86. Information about new IFRS standards and amendments to standards are disclosed in Notes 86.33-34.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 22 February 2016.

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

## 3. 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. At the year end the exchange rate of the ISK against the USD was 129.59 and 141.32 for the EUR (2014: USD 126.9 and EUR 154.27).

## 4. 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 Group's management discusses with the Audit Committee the development, selection and disclosure of the Group'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) *Impairment of loans measured at amortised cost*

The Group'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 Group'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 Group.

# Notes to the Consolidated Financial Statements

4. Cont'd

When scheduling its future cash flows the Group'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 86.27.

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

On 2 November 2015, Visa Inc. and Visa Europe Ltd. announced a transaction whereby Visa Inc. will acquire Visa Europe Ltd. (the “Transaction”). The Transaction consists of an upfront cash payment of EUR 11.5 billion, convertible preferred shares valued at EUR 5.0 billion at the time of announcement, and a conditional cash payment of up to EUR 4.7 billion, payable after the fourth anniversary of the closing of the Transaction. The Transaction is expected to close in the 2nd quarter of 2016 and is subject to approval from competition authorities in the affected markets.

The fair value assessment of Borgun's share in Visa Europe Ltd. at 31 December 2015 is based on available information of the transaction on the assessment date alongside management's assessment on the key variables that are not considered market information and are classified as Level 3 for the valuation of the fair value. Management's approach for assessment is based on the assessed value of each item that will be paid considering the possibility of whether that item will be realised.

The estimated fair value of the cash payment and preferred shares related to the Transaction of total ISK 5.445 million has been entered as an asset „available for sale“ in the line item "Shares and equity instruments" in the statement of financial position per 31 December (see Note 7 and 8).

# Notes to the Consolidated Financial Statements

## Operating segments

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

The accounting policies for the reportable segments are in line with the Group'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 Group is organised into six main operating segments based on products and services:

a) Retail Banking provides comprehensive banking services to individuals and small and medium-sized enterprises through 17 branches, call centre, self service and digital banking platforms. Retail Banking also operates two separately branded units, Ergo for asset- based financing and Kreditkort, a special credit card branch.

b) Corporate Banking provides comprehensive lending and advisory services to large businesses and municipalities in Iceland. In addition, it manages the Group's international business in the North Atlantic region, primarily focusing on the seafood and offshore supply vessel industries. Corporate Banking is leading in its field. The division has extensive experience servicing established sectors such as seafood, energy and real estate as well as growing industries such as retail and tourism.

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.

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 companies Íslandssjódir and Summa.

e) Treasury is responsible for funding the Group's operations and for managing an internal pricing framework. The division is also responsible for information sharing regarding internal prices, funding and the financial position of the Group, and for each of its individual units, to the relevant parties inside and outside the Group. Treasury is responsible for the Group's annual budgeting process and for the management of liquidity risk, foreign exchange risk, inflation risk and interest rate risk within regulatory requirements and internal limits established by the Board of Directors. The division also manages relations with investors, financial institutions, stock exchanges and rating agencies.

f) Subsidiaries & Equity Investments include equity investments in the banking book and subsidiaries, the most significant being:
- Borgun hf., a credit card settlement company
- Allianz Ísland hf., an agent for the German insurance company Allianz, and its holding company Hringur eignarhaldsfélag ehf.
- D1 ehf., a commercial real estate company which holds and manages a portfolio of properties for leasing, thereof 15 properties leased by the Group.

Cost centres comprise Head Office, Human Resources, Legal, Risk Management, Finance, Operations & IT, Group Internal Audit, Compliance and Business Development

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

# Notes to the Consolidated Financial Statements

5. Cont'd

**The year 2015**

| **Operations** | Retail Banking | Corporate Banking | Markets | Wealth Manage-ment | Treasury | Subsidiaries & Equity Investments | Cost Centres & Eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 17,880 | 5,081 | 1,066 | 639 | 3,579 | 142 | ( 377) | 28,010 |
| Net fee and commission income | 4,434 | 216 | 1,520 | 2,208 | ( 146) | 4,932 | 5 | 13,170 |
| Other operating income (expenses) | 55 | 4 | 415 | 314 | ( 1,505) | 4,690 | ( 480) | 3,493 |
| Total operating income | 22,369 | 5,302 | 3,002 | 3,161 | 1,928 | 9,764 | ( 853) | 44,673 |
| Salaries and related expenses | ( 4,190) | ( 484) | ( 892) | ( 992) | ( 117) | ( 1,763) | ( 5,454) | ( 13,891) |
| Other operating expenses | ( 2,261) | ( 80) | ( 149) | ( 205) | ( 188) | ( 1,926) | ( 5,060) | ( 9,869) |
| Depositors' Guarantee Fund and bank tax | ( 968) | ( 20) | ( 0) | ( 62) | ( 2,894) | ( 0) | - | ( 3,945) |
| Net loan impairment | 3,017 | 4,513 | ( 0) | 187 | - | 560 | ( 142) | 8,135 |
| Profit (loss) before cost allocation & tax | 17,968 | 9,230 | 1,960 | 2,090 | ( 1,271) | 6,635 | ( 11,509) | 25,103 |
| Net segment revenue from external customers | 22,721 | 12,641 | 3,419 | 1,085 | ( 5,368) | 10,611 | ( 435) | 44,673 |
| Net segment revenue from other segments | ( 352) | ( 7,339) | ( 417) | 2,076 | 7,297 | ( 848) | ( 417) | - |
| Depreciation and amortisation | ( 194) | ( 3) | ( 1) | ( 3) | ( 0) | ( 188) | ( 420) | ( 810) |
| **At 31 December 2015** | | | | | | | | |
| Total segment assets | 439,920 | 227,107 | 11,833 | 4,124 | 308,166 | 74,133 | ( 19,514) | 1,045,769 |
| Total segment liabilities | 415,525 | 7,962 | 5,064 | 44,109 | 347,208 | 41,398 | ( 17,724) | 843,542 |
| Allocated equity | 48,355 | 34,146 | 2,898 | 3,130 | 101,749 | 19,046 | ( 7,097) | 202,227 |

**The year 2014**

| **Operations** | Retail Banking | Corporate Banking | Markets | Wealth Manage-ment | Treasury | Subsidiaries & Equity Investments | Cost Centres & Eliminations | Total |
|---|---|---|---|---|---|---|---|---|
| Net interest income | 17,261 | 4,427 | 911 | 731 | 4,736 | ( 510) | ( 451) | 27,105 |
| Net fee and commission income | 4,421 | 122 | 1,499 | 1,939 | ( 80) | 3,562 | 20 | 11,483 |
| Other operating income (expenses) | 77 | 386 | ( 98) | 79 | 15 | 3,003 | 393 | 3,855 |
| Total operating income | 21,759 | 4,935 | 2,312 | 2,749 | 4,671 | 6,055 | ( 38) | 42,443 |
| Salaries and related expenses | ( 4,019) | ( 432) | ( 874) | ( 912) | ( 88) | ( 1,484) | ( 5,499) | ( 13,307) |
| Other operating expenses | ( 2,375) | ( 70) | ( 127) | ( 207) | ( 181) | ( 1,919) | ( 4,716) | ( 9,594) |
| Depositors' Guarantee Fund and bank tax | ( 921) | ( 21) | ( 0) | ( 74) | ( 2,483) | ( 0) | - | ( 3,499) |
| Net loan impairment | 6,588 | 1,489 | - | ( 2) | 34 | 1,016 | ( 315) | 8,810 |
| Profit (loss) before cost allocation & tax | 21,033 | 5,902 | 1,312 | 1,554 | 1,953 | 3,667 | ( 10,568) | 24,853 |
| Net segment revenue from external customers | 22,132 | 8,335 | 2,624 | 1,387 | 1,277 | 6,478 | 210 | 42,443 |
| Net segment revenue from other segments | ( 372) | ( 3,401) | ( 312) | 1,362 | 3,394 | ( 423) | ( 248) | 0 |
| Depreciation and amortisation | ( 180) | - | ( 2) | ( 2) | - | ( 179) | ( 600) | ( 963) |
| **At 31 December 2014** | | | | | | | | |
| Total segment assets | 413,812 | 225,100 | 13,161 | 4,171 | 202,089 | 87,998 | ( 35,003) | 911,328 |
| Total segment liabilities | 397,343 | 14,401 | 783 | 49,867 | 243,479 | 43,231 | ( 23,263) | 725,841 |
| Allocated equity | 41,792 | 28,314 | 1,494 | 2,685 | 105,512 | 25,794 | ( 20,105) | 185,487 |

# Notes to the Consolidated Financial Statements

## Quarterly statements

6. Operations by quarters:

| 2015 | Q4* | Q3* | Q2* | Q1* | Total |
|---|---|---|---|---|---|
| Net interest income | 7,003 | 7,457 | 7,359 | 6,191 | 28,010 |
| Net fee and commission income | 3,235 | 3,512 | 3,518 | 2,905 | 13,170 |
| Net financial income | 1,455 | 387 | 275 | 1,764 | 3,881 |
| Net foreign exchange loss | ( 137) | ( 1,072) | ( 141) | ( 140) | ( 1,490) |
| Other operating income | 403 | 158 | 252 | 289 | 1,102 |
| Salaries and related expenses | ( 3,670) | ( 3,340) | ( 3,421) | ( 3,460) | ( 13,891) |
| Other operating expenses | ( 2,848) | ( 1,970) | ( 2,688) | ( 2,363) | ( 9,869) |
| Contribution to the Depositors' and Investors' Guarantee Fund | ( 270) | ( 263) | ( 265) | ( 269) | ( 1,067) |
| Bank tax | ( 818) | ( 732) | ( 710) | ( 618) | ( 2,878) |
| Net loan impairment | 409 | 3,418 | 1,977 | 2,331 | 8,135 |
| Profit before tax | 4,762 | 7,555 | 6,156 | 6,630 | 25,103 |
| Income tax expense | ( 1,147) | ( 1,784) | ( 1,524) | ( 1,396) | ( 5,851) |
| Profit for the period from continuing operations | 3,615 | 5,771 | 4,632 | 5,234 | 19,252 |
| Profit from discontinued operations, net of income tax | 274 | 128 | 762 | 162 | 1,326 |
| **Profit for the period** | 3,889 | 5,899 | 5,394 | 5,396 | 20,578 |

| 2014 | Q4* | Q3* | Q2* | Q1* | Total |
|---|---|---|---|---|---|
| Net interest income | 6,469 | 7,068 | 6,922 | 6,646 | 27,105 |
| Net fee and commission income | 2,962 | 2,849 | 2,818 | 2,854 | 11,483 |
| Net financial income | 603 | 83 | 19 | 863 | 1,568 |
| Net foreign exchange gain (loss) | 116 | 352 | ( 12) | ( 291) | 165 |
| Other operating income | 509 | 233 | 267 | 1,113 | 2,122 |
| Salaries and related expenses | ( 3,497) | ( 2,930) | ( 3,441) | ( 3,439) | ( 13,307) |
| Other operating expenses | ( 2,914) | ( 2,301) | ( 1,909) | ( 2,470) | ( 9,594) |
| Contribution to the Depositors' and Investors' Guarantee Fund | ( 265) | ( 272) | ( 260) | ( 258) | ( 1,055) |
| Bank tax | ( 565) | ( 664) | ( 623) | ( 592) | ( 2,444) |
| Net loan impairment | 3,006 | 65 | 4,219 | 1,520 | 8,810 |
| Profit before tax | 6,424 | 4,483 | 8,000 | 5,946 | 24,853 |
| Income tax expense | ( 1,434) | ( 1,255) | ( 2,156) | ( 1,394) | ( 6,239) |
| Profit for the period from continuing operations | 4,990 | 3,228 | 5,844 | 4,552 | 18,614 |
| (Loss) profit from discontinued operations, net of income tax | ( 430) | 307 | 515 | 3,744 | 4,136 |
| **Profit for the period** | 4,560 | 3,535 | 6,359 | 8,296 | 22,750 |

* The half-year results were reviewed by the Group's auditor. The quarterly statements and the split between quarters were not reviewed or audited by the Group's auditor.

# 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 2015** | Notes | Held for trading | Designated at fair value through P&L | Loans & receivables | Available for sale | Liabilities at amortised cost | Total carrying amount |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 27 | - | - | 216,760 | - | - | 216,760 |
| *Loans and receivables* | | | | | | | |
| Loans to credit institutions | 29 | - | - | 35,534 | - | - | 35,534 |
| Loans to customers | 30-31 | - | - | 665,711 | - | - | 665,711 |
| **Loans and receivables** | | - | - | 918,005 | - | - | 918,005 |
| *Bonds and debt instruments* | | | | | | | |
| Listed | | 44,443 | 31,341 | - | - | - | 75,784 |
| Unlisted | | | 2,822 | - | - | - | 2,822 |
| **Bonds and debt instruments** | | 44,443 | 34,163 | - | - | - | 78,606 |
| *Shares and equity instruments* | | | | | | | |
| Listed | | 7,993 | 3,218 | - | - | - | 11,211 |
| Unlisted | | - | 1,664 | - | 5,445 | - | 7,109 |
| **Shares and equity instruments** | | 7,993 | 4,882 | - | 5,445 | - | 18,320 |
| Derivatives | 28 | 1,981 | - | - | - | - | 1,981 |
| Other financial assets | | - | - | 5,535 | - | - | 5,535 |
| **Total financial assets** | | 54,417 | 39,045 | 923,540 | 5,445 | - | 1,022,447 |
| | | | | | | | |
| Deposits from Central Bank and credit institutions | 41 | - | - | - | - | 25,631 | 25,631 |
| Deposits from customers | 42-43 | - | - | - | - | 593,245 | 593,245 |
| Derivative instruments and short positions | 28 | 6,981 | - | - | - | - | 6,981 |
| Debt issued and other borrowed funds | 45 | - | - | - | - | 150,308 | 150,308 |
| Subordinated loans | 46 | - | - | - | - | 19,517 | 19,517 |
| Other financial liabilities | | - | - | - | - | 26,642 | 26,642 |
| **Total financial liabilities** | | 6,981 | - | - | - | 815,343 | 822,324 |

7. Cont'd

| At 31 December 2014 | Notes | Held for trading | Designated at fair value through P&L | Loans & receivables | Available for sale | Liabilities at amortised cost | Total carrying amount |
|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 27 | - | - | 103,389 | - | - | 103,389 |
| *Loans and receivables* | | | | | | | |
| Loans to credit institutions | 29 | - | - | 35,072 | - | - | 35,072 |
| Loans to customers | 30-31 | - | - | 634,799 | - | - | 634,799 |
| **Loans and receivables** | | - | - | 773,260 | - | - | 773,260 |
| *Bonds and debt instruments* | | | | | | | |
| Listed | | 54,273 | 31,347 | - | - | - | 85,620 |
| Unlisted | | - | 1,727 | - | - | - | 1,727 |
| **Bonds and debt instruments** | | 54,273 | 33,074 | - | - | - | 87,347 |
| *Shares and equity instruments* | | | | | | | |
| Listed | | 4,810 | 2,917 | - | - | - | 7,727 |
| Unlisted | | - | 2,804 | - | - | - | 2,804 |
| **Shares and equity instruments** | | 4,810 | 5,721 | - | - | - | 10,531 |
| Derivatives | 28 | 1,810 | - | - | - | - | 1,810 |
| Other financial assets | | - | - | 6,567 | - | - | 6,567 |
| **Total financial assets** | | 60,893 | 38,795 | 779,827 | - | - | 879,515 |
| Deposits from Central Bank and credit institutions | 41 | - | - | - | - | 25,796 | 25,796 |
| Deposits from customers | 42-43 | - | - | - | - | 529,447 | 529,447 |
| Derivative instruments and short positions | 28 | 3,963 | - | - | - | - | 3,963 |
| Debt issued and other borrowed funds | 45 | - | - | - | - | 96,889 | 96,889 |
| Subordinated loans | 46 | - | - | - | - | 21,306 | 21,306 |
| Other financial liabilities | | - | - | - | - | 25,363 | 25,363 |
| **Total financial liabilities** | | 3,963 | - | - | - | 698,801 | 702,764 |

## Fair value information for financial instruments

### 8. Financial instruments carried at fair value

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

The table below shows financial instruments carried at fair value categorised into levels of fair value hierarchy that reflect the significance of inputs used in making the fair value measurements as at 31 December 2015. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

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

Level 3: Inputs that are unobservable, e.g. internal assumptions.

**At 31 December 2015**

| **Financial assets:** | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 45,227 | 32,732 | 647 | 78,606 |
| Shares and equity instruments | 11,348 | 1,527 | 5,445 | 18,320 |
| Derivative instruments | - | 1,981 | - | 1,981 |
| **Total financial assets** | 56,575 | 36,240 | 6,092 | 98,907 |
| **Financial liabilities:** | | | | |
| Short positions | 3,771 | 302 | - | 4,073 |
| Derivative instruments | - | 2,908 | - | 2,908 |
| **Total financial liabilities** | 3,771 | 3,210 | - | 6,981 |

**At 31 December 2014**

| **Financial assets:** | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Bonds and debt instruments | 54,618 | 31,539 | 1,190 | 87,347 |
| Shares and equity instruments | 7,618 | 98 | 2,815 | 10,531 |
| Derivative instruments | - | 1,810 | - | 1,810 |
| **Total financial assets** | 62,236 | 33,447 | 4,005 | 99,688 |
| **Financial liabilities:** | | | | |
| Short positions | 686 | - | - | 686 |
| Derivative instruments | - | 3,184 | 93 | 3,277 |
| **Total financial liabilities** | 686 | 3,184 | 93 | 3,963 |

8. Cont'd

**Reconciliation of financial assets and liabilities categorised into Level 3**

| January-December 2015 | Bonds and debt instruments | Shares and equity instruments | Derivatives |
|---|---|---|---|
| Fair value at 1 January 2015 | 1,190 | 2,816 | ( 93) |
| Purchases | - | 689 | - |
| Sales | - | ( 1,315) | - |
| Net gains on financial instruments | ( 543) | 6,263 | ( 2) |
| Transfers from level 1 or 2 | - | - | - |
| Transfers to level 1 or 2 | - | ( 3,008) | 95 |
| **Fair value at 31 December 2015** | 647 | 5,445 | - |

| January-December 2014 | Bonds and debt instruments | Shares and equity instruments | Derivatives |
|---|---|---|---|
| Fair value at 1 January 2014 | 1,279 | 2,791 | ( 85) |
| Purchases | - | 709 | - |
| Sales | ( 32) | ( 383) | - |
| Net gains on financial instruments recognised in profit or loss | ( 57) | 459 | ( 8) |
| Transfers from level 1 or 2 | - | - | - |
| Transfers to level 1 or 2 | - | ( 760) | - |
| **Fair value at 31 December 2014** | 1,190 | 2,816 | ( 93) |

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

The objective of this valuation process is to arrive at a fair value measurement which reflects the price of the asset or liability that would be paid or received in an orderly transaction between market participants at the measurement date.

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. The Group defines an active market as one where transactions take place with sufficient frequency and volume. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

Level 1 financial assets and financial liabilities contain actively traded bonds and equities that are listed either domestically or abroad. Three equity instrument, a total of ISK 2,086 million, were transferred from Level 3 to Level 1 due to their listing on the domestic market.

Level 2 assets and liabilities contain illiquid bonds in the domestic markets, unlisted equities as well as derivatives. The Group classifies mutual fund units as shares and equity instruments in Level 2 and estimates the fair value for these units based on NAV where the unit prices are not readily available. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign currency forwards and foreign currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates. In general bond options are classified as Level 2.

One equity instrument, a total of ISK 234 million, was transferred to Level 2 as its value is now derived from its listed assets. Equity instruments worth ISK 688 million and bond options worth ISK -95 million were transferred to Level 2 following a revision of the significancy of the unobservable inputs used in their valuation models.

Level 3 assets contain primarily unlisted and illiquid equities and bonds. Unlisted equities are initially booked at their transaction price but are revalued each quarter based on the models as described above. They are classified as Level 3. The Group's Level 3 equities amounted to ISK 5,445 million. They were valued by discounting their most recent transaction price due to uncertainty regarding various issues, such as regulatory and legal issues. The valuation is as such sensitive to these discount factors which were between 0% and 3% . All things equal, higher discount factors would lead to a lower fair value and lower discount factors to a higher fair value.

The Group's Level 3 bonds amounted to ISK 647 million and were valued based on expected recovery of the bond issuers' assets. The expected recovery of these bonds ranges from 0% to 75% and is subject to uncertainty regarding various assumptions, such as the outcome of legal disputes. An increase or decrease in the expected recovery would result in a similar change in the fair value.

## 9. Financial instruments not carried at fair value

The table below shows the fair value measurement and classification of financial assets and liabilities not carried at fair value at 31 December 2015. The different levels are defined as before (see Note 8).

*Assets*

Loans to customers on the Group's balance sheet that are carried at amortised cost consist of two types:

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

Loans in category 1) are specifically assessed for impairment at least every six months and every three months for significant amounts and therefore their carrying amount is considered a good approximation of their fair value. Since measurement is partially based on internal models they are classified as Level 3. The fair value of the loans in category 2) may differ from their carrying amount because the interest rate they carry may not reflect the interest rate that similar new loans would carry. This difference stems from two sources:

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

The Group calculates the fair value of loans in category 2) by discounting from the carrying amount the resulting interest rate difference from 31 December 2015 to the loan's next interest reset or maturity, whichever comes first. Since the credit-worthiness is estimated using the Group's internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is very well approximated by the carrying amount since they are short term in nature. They are thus classified as Level 2.

*Liabilities*

The fair value of a financial liability with a demand feature, such as a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

On the liabilities side most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. For longer term, fixed rate deposits the Group calculates the fair value with a duration approach, using the difference in each liability´s current interest rate from the rate that a similar deposit would carry today. The fair value estimate of deposits does not take into account the effect of the Payment Service Directive on interest reset dates. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

For the fair value of "Debt issued and other borrowed funds" the Group uses an observed market value where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The Group estimates its funding premium based on the interest margin on its issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

The fair value of liabilities in "Subordinated loans" is estimated using a duration approach by comparing the contractual interest margin with the interest margin in the market on the Group's issuance in foreign currency plus a margin to account for the fact that the subordinated liabilities are junior to the market traded debt. These liabilities are classified as Level 2.

Other financial liabilities mainly include unsettled securities transactions and liabilities to retailers for credit card provision and are classified as level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

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

| At 31 December 2015 | Level 1 | Level 2 | Level 3 | Total fair value | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets:** | | | | | |
| Cash and balances with Central Bank | - | 216,760 | - | 216,760 | 216,760 |
| Loans to credit institutions | - | 35,534 | - | 35,534 | 35,534 |
| Loans to customers | - | - | 668,265 | 668,265 | 665,711 |
| Other financial assets | - | 5,534 | - | 5,534 | 5,534 |
| **Total financial assets** | - | 257,828 | 668,265 | 926,093 | 923,539 |

9. Cont'd

| At 31 December 2015 | Level 1 | Level 2 | Level 3 | Total fair value | Carrying amount |
|---|---|---|---|---|---|
| **Financial liabilities:** | | | | | |
| Deposits from Central Bank and credit institutions | - | 25,631 | - | 25,631 | 25,631 |
| Deposits from customers | - | 593,402 | - | 593,402 | 593,245 |
| Debt issued and other borrowed funds | 59,294 | 91,149 | - | 150,443 | 150,308 |
| Subordinated loans | - | 19,517 | - | 19,517 | 19,517 |
| Other financial liabilities | - | 26,642 | - | 26,642 | 26,642 |
| **Total financial liabilities** | 59,294 | 756,341 | - | 815,635 | 815,343 |

| At 31 December 2014 | Level 1 | Level 2 | Level 3 | Total fair value | Carrying amount |
|---|---|---|---|---|---|
| **Financial assets:** | | | | | |
| Cash and balances with Central Bank | - | 103,389 | - | 103,389 | 103,389 |
| Loans to credit institutions | - | 35,072 | - | 35,072 | 35,072 |
| Loans to customers | - | - | 636,141 | 636,141 | 634,799 |
| Other financial assets | - | 6,567 | - | 6,567 | 6,567 |
| **Total financial assets** | - | 145,028 | 636,141 | 781,169 | 779,827 |
| **Financial liabilities:** | | | | | |
| Deposits from Central Bank and credit institutions | - | 25,796 | - | 25,796 | 25,796 |
| Deposits from customers | - | 529,519 | - | 529,519 | 529,447 |
| Debt issued and other borrowed funds | 37,293 | 59,601 | - | 96,894 | 96,889 |
| Subordinated loans | - | 21,306 | - | 21,306 | 21,306 |
| Other financial liabilities | - | 25,363 | - | 25,363 | 25,363 |
| **Total financial liabilities** | 37,293 | 661,585 | - | 698,878 | 698,801 |

## Offsetting financial assets and financial liabilities

10. Offsetting financial assets and financial liabilities

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

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

| | Financial assets subject to netting arrangements | | | Amounts not set off but subject to master netting arrangements and similar agreements | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2015** | Gross recognised financial assets before balance sheet netting | Balance sheet netting with gross recognised financial liabilities | Financial assets recognised on the balance sheet, net | Recognised financial liabilities | Cash collateral received | Financial instruments collateral received | Net amount after consideration of potential effect of netting arrangements | Assets outside the scope of offsetting disclosure requirements | Total assets recognised on the balance sheet |
| Derivatives ........................... | 1,981 | - | 1,981 | ( 696) | ( 31) | ( 1) | 1,253 | - | 1,981 |
| **Total assets** | 1,981 | - | 1,981 | ( 696) | ( 31) | ( 1) | 1,253 | - | 1,981 |
| **At 31 December 2014** | | | | | | | | | |
| Derivatives ........................... | 1,810 | - | 1,810 | ( 306) | ( 48) | ( 18) | 1,438 | - | 1,810 |
| **Total assets** | 1,810 | - | 1,810 | ( 306) | ( 48) | ( 18) | 1,438 | - | 1,810 |

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

| | Financial liabilities subject to netting arrangements | | | Amounts not set off but subject to master netting arrangements and similar agreements | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **At 31 December 2015** | Gross recognised financial liabilities before balance sheet netting | Balance sheet netting with gross recognised financial assets | Financial liabilities recognised on the balance sheet, net | Recognised financial assets | Cash collateral pledged | Financial instruments collateral pledged | Net amount after consideration of potential effect of netting arrangements | Liabilities outside the scope of offsetting disclosure requirements | Total liabilities recognised on the balance sheet |
| Derivative instruments and short positions ................... | 2,908 | - | 2,908 | ( 696) | - | - | 2,212 | 4,073 | 6,981 |
| **Total liabilities** | 2,908 | - | 2,908 | ( 696) | - | - | 2,212 | 4,073 | 6,981 |
| **At 31 December 2014** | | | | | | | | | |
| Derivative instruments and short positions .................... | 3,277 | - | 3,277 | ( 306) | - | ( 1,899) | 1,072 | 686 | 3,963 |
| **Total liabilities** | 3,277 | - | 3,277 | ( 306) | - | ( 1,899) | 1,072 | 686 | 3,963 |

# Notes to the Consolidated Financial Statements

## Net interest income

11. Net interest income is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| **Interest income:** | | |
| Cash and balances with Central Bank | 7,394 | 6,671 |
| Loans and receivables | 43,303 | 40,331 |
| Financial assets held for trading | 980 | 1,957 |
| Financial assets designated at fair value through profit or loss | 1,558 | 1,672 |
| Other assets | 179 | 185 |
| **Total interest income** | 53,414 | 50,816 |
| **Interest expense:** | | |
| Deposits from credit institutions and Central Bank | ( 517) | ( 479) |
| Deposits from customers | ( 18,240) | ( 16,919) |
| Borrowings | ( 5,427) | ( 4,750) |
| Subordinated loans | ( 1,015) | ( 911) |
| Other financial liabilities | ( 147) | ( 295) |
| Other interest expense | ( 58) | ( 357) |
| **Total interest expense** | ( 25,404) | ( 23,711) |
| **Net interest income** | 28,010 | 27,105 |
| Interest spread (as the ratio of net interest income to the average carrying amount of total assets) | 2.9% | 3.0% |

## Net fee and commission income

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

| | 2015 | 2014 |
|---|---|---|
| **Fee and commission income:** | | |
| Asset management | 1,778 | 1,683 |
| Investment banking and brokerage | 2,132 | 1,833 |
| Payment processing | 13,664 | 11,627 |
| Loans and guarantees | 1,498 | 1,267 |
| Other fees and commissions income | 1,665 | 1,574 |
| **Total fee and commission income** | 20,737 | 17,984 |
| **Commission expenses:** | | |
| Interbank charges | - | ( 157) |
| Brokerage | ( 121) | ( 128) |
| Clearing and settlement | ( 7,415) | ( 6,179) |
| Other commission expenses | ( 31) | ( 37) |
| **Total commission expenses** | ( 7,567) | ( 6,501) |
| **Net fee and commission income** | 13,170 | 11,483 |

# Notes to the Consolidated Financial Statements

## Net financial income

13. Net financial income is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Net gain on financial assets and liabilities held for trading | 1,375 | 7 |
| Net gain on financial assets designated at fair value through profit or loss | 2,506 | 1,561 |
| **Net financial income** | 3,881 | 1,568 |

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

14. Net gain on financial assets and liabilities held for trading is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Shares and related derivatives | 487 | ( 274) |
| Dividend income on shares held for trading | 105 | 185 |
| Bonds and related derivatives | 530 | ( 176) |
| Other derivatives | 253 | 272 |
| **Net gain on financial assets and liabilities held for trading** | 1,375 | 7 |

## 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 is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Shares | 2,324 | 1,596 |
| Bonds | 182 | ( 35) |
| **Net gain on financial assets designated at fair value through profit or loss** | 2,506 | 1,561 |

## Net foreign exchange (loss) gain

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

| | 2015 | 2014 |
|---|---|---|
| **Assets:** | | |
| Cash and balances with Central Bank | ( 136) | ( 42) |
| Financial assets held for trading | ( 4,315) | ( 1,314) |
| Loans and receivables | ( 6,255) | 1,989 |
| Other assets | 89 | 754 |
| **Total** | ( 10,617) | 1,387 |
| **Liabilities:** | | |
| Deposits | 4,705 | ( 2,246) |
| Subordinated loans | 1,787 | 584 |
| Debt issued and other borrowed funds | 2,918 | 1,106 |
| Other liabilities | ( 283) | ( 666) |
| **Total** | 9,127 | ( 1,222) |
| **Net foreign exchange (loss) gain** | ( 1,490) | 165 |

# Notes to the Consolidated Financial Statements

## Other operating income

17. Other operating income is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Agency fees and service level agreement fees | 194 | 269 |
| Rental income from real estate | 102 | 143 |
| Rental income from foreclosed assets | 183 | 282 |
| Legal cost and fees | 171 | 148 |
| Realised gain on property and equipment | 23 | 242 |
| Share of profit or loss of associates | 63 | 27 |
| Other operating income | 366 | 1,011 |
| **Other operating income** | 1,102 | 2,122 |

## Salaries and related expenses

18. Salaries and related expenses are specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Salaries | 10,869 | 10,193 |
| Pension and similar expenses | 1,585 | 1,491 |
| Social security charges and financial activities tax* | 1,507 | 1,460 |
| Other | 205 | 163 |
| Capitalisation of internal staff costs in software development | ( 274) | - |
| **Salaries and related expenses** | 13,891 | 13,307 |

*Financial activities tax calculated on salaries 5.5% (2014: 5.5%).

The Group made a provision of ISK 378 million (2014: ISK 358 million) for potential performance plan payments. In accordance with the FME rules no. 700/2011, part of the payment is deferred for a minimum of 3 years. Salary related expenses are included in the amount.

The performance based salaries are based on FME rules on remuneration policy for financial undertakings (700/2011). The rules reflect a conservative framework for remuneration schemes within the financial sector. The remuneration policy shall not encourage unreasonable risk taking, nor contravene the long-term interests of the undertaking and the stability of the financial system. The policy shall conform to viewpoints related to the protection of the undertaking's customers, its creditors and shareholders or guarantee capital owners and in other respects conform to proper and sound business practices. The rules state that the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years if the variable remuneration is in excess of 10% of the annual salary of the person in question, exclusive of variable remuneration. Risk management, compliance and internal audit shall review and analyse whether variable remuneration complies with the undertaking's remuneration policy and the FME rules. The rules prohibit employees in these units to be paid performance based salaries.

19. The Group's total number of employees is as follows:

| | 31 December 2015 | | 31 December 2014 | |
|---|---|---|---|---|
| | Parent Company | The Group | Parent Company | The Group |
| Average number of employees | 958 | 1,222 | 990 | 1,253 |
| Positions at the end of the year | 919 | 1,184 | 945 | 1,206 |

Average number of employees for the Group in 2015 includes 108 employees (2014: 114 employees) in disposal groups held for sale, whose salaries are not included in the salaries and related expenses.

# Notes to the Consolidated Financial Statements

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

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

| | Salaries | |
|---|---|---|
| | 2015 | 2014 |
| Fridrik Sophusson, Chairman of the Board | 9.0 | 7.5 |
| Marianne Økland, Vice-Chairman of the Board | 6.6 | 5.4 |
| Árni Tómasson, member of the Board | 6.2 | 5.4 |
| Eva Cederbalk, member of the Board | 5.2 | - |
| Gunnar Fjalar Helgason, member of the Board | 1.2 | - |
| Helga Valfells, member of the Board | 6.2 | 5.8 |
| Neil Graeme Brown, member of the Board | 6.6 | 5.4 |
| John E. Mack, former Vice-Chairman of the Board | 1.6 | 5.4 |
| Daniel Levin, former member of the Board | - | 3.6 |
| María E. Ingvadóttir, former member of the Board | - | 4.1 |
| Thóranna Jónsdóttir, former member of the Board | 4.5 | 5.8 |
| Alternate board members | 0.2 | - |
| **Total** | 47.2 | 48.4 |

| | 2015 | | 2014 | |
|---|---|---|---|---|
| | Salaries | Performance based payments* | Salaries | Performance based payments* |
| Birna Einarsdóttir, CEO | 43.7 | 7.2 | 38.6 | 4.8 |
| 8 Managing Directors | 221.3 | 29.1 | 198.7 | 22.4 |

*According to the FME rules on variable remuneration, the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. If the employee gives a notice of termination, the employee shall no longer be entitled to the deferred payment. In 2015 a deferred payment was paid out for the first time, 40% remainder from 2011.

The employer's contribution to pension funds and other benefits for the Board, CEO and Management Board amounted to ISK 64.3 million in 2015 (2014: ISK 52.9million). There were no share based payments in the years 2015 and 2014.

## Other operating expenses

21. Other operating expenses are specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Professional services | 4,117 | 3,792 |
| Real estate and fixtures | 2,795 | 2,714 |
| Depreciation and amortisation | 808 | 963 |
| Other administrative expenses | 2,149 | 2,125 |
| **Other operating expenses** | 9,869 | 9,594 |

## Auditors' fees

22. Auditors' fees are as follows:

| | 2015 | 2014 |
|---|---|---|
| Audit of the annual accounts | 113 | 94 |
| Review of interim accounts | 29 | 27 |
| Other services | 43 | 42 |
| **Auditors' fees** | 185 | 163 |

## Net loan impairment

23. Net loan impairment:

| | 2015 | 2014 |
|---|---|---|
| **Loan impairment charged to the income statement:** | | |
| Specific impairment losses on loans | ( 3,567) | ( 2,822) |
| Collective impairment | 383 | 967 |
| Total impairment charged to the income statement (see Note 31) | ( 3,184) | ( 1,855) |
| **Net loan impairment:** | | |
| Impairment reversal due to revised estimated future cash flows | 11,319 | 10,665 |
| Specific impairment losses on loans | ( 3,567) | ( 2,822) |
| Net loan impairment before collective impairment | 7,752 | 7,843 |
| Collective impairment | 383 | 967 |
| **Total net loan impairment** | 8,135 | 8,810 |

## Profit from discontinued operations

24. Profit from discontinued operations are specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Net profit from sale of foreclosed mortgages | 646 | 1,589 |
| Net share of loss from disposal groups held for sale | 653 | ( 941) |
| Net profit from sale of subsidiaries and associates | 27 | 3,488 |
| **Profit from discontinued operations** | 1,326 | 4,136 |

## Income taxes

25. Income tax for the year 2015 is calculated at 20%. Special financial activities tax (FAT) is calculated as 6% of taxable profits above ISK 1 billion. The effective income tax rate in the Group's income statement for 2015 is 23.3%.

Income tax recognised in the income statement is specified as follows:

| | 2015 | 2014 |
|---|---|---|
| Current tax expense | 4,027 | 4,423 |
| Special financial activities tax | 1,046 | 1,275 |
| Difference in prior year's imposed and calculated income tax | ( 34) | ( 103) |
| Origination and reversal of temporary differences due to deferred tax assets/liabilities | 812 | 644 |
| **Total** | 5,851 | 6,239 |

The effective income tax rate is specified as follows:

| | 2015 | | 2014 | |
|---|---|---|---|---|
| Profit before tax | 25,103 | | 24,853 | |
| 20% income tax calculated on the profit of the year | 5,021 | 20.0% | 4,971 | 20.0% |
| Special financial activities tax | 1,046 | 4.2% | 1,275 | 5.1% |
| Income not subject to tax | ( 820) | (3.3%) | ( 976) | (3.9%) |
| Non-deductable expenses | 565 | 2.3% | 471 | 1.9% |
| Other differences | 39 | 0.2% | 498 | 2.0% |
| **Income tax expense** | 5,851 | 23.3% | 6,239 | 25.1% |

The Group 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.

# Notes to the Consolidated Financial Statements

## Earnings per share

26. Earnings per share are specified as follows:

| | Discontinued operations | | | |
|---|---|---|---|---|
| | Excluded | | Included | |
| | 2015 | 2014 | 2015 | 2014 |
| Net profit to the equity holders of the parent, according to the consolidated income statement | 18,674 | 17,604 | 20,000 | 21,740 |
| Weighted average number of outstanding shares for the period, million | 10,000 | 10,000 | 10,000 | 10,000 |
| Basic earnings per share | 1.87 | 1.76 | 2.00 | 2.17 |

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2014: none).

## Cash and balances with Central Bank

27. Specification of cash and balances with Central Bank:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Cash on hand | 2,784 | 2,256 |
| Balances with Central Bank other than mandatory reserve deposits | 15,458 | 10,738 |
| Term deposits | 183,539 | 80,843 |
| **Included in cash and cash equivalents** | 201,781 | 93,837 |
| Mandatory reserve deposits with Central Bank | 14,979 | 9,552 |
| **Cash and balances with Central Bank** | 216,760 | 103,389 |

The average balance of the Central Bank current account for each month must be equivalent to at least mandatory reserve deposits, amounted to ISK 14,979 million (December 2014: ISK 9,629 million).

## Derivative instruments and short positions

28. Derivative instruments and short positions:

**At 31 December 2015**

| | Assets | Notional values related to assets | Liabilities | Notional values related to liabilities |
|---|---|---|---|---|
| Interest rate swaps | 533 | 13,687 | 1,435 | 37,340 |
| Cross currency interest rate swaps | 1,138 | 26,212 | 148 | 10,209 |
| Equity forwards | 56 | 1,283 | 588 | 3,003 |
| Foreign exchange forwards | 21 | 1,551 | 391 | 7,687 |
| Foreign exchange swaps | 82 | 9,918 | 236 | 17,034 |
| Bond forwards | 151 | 3,015 | 14 | 920 |
| Bond options | - | - | 96 | 25,000 |
| **Derivatives** | 1,981 | 55,666 | 2,908 | 101,193 |
| Short positions in listed bonds | - | - | 4,073 | - |
| **Total** | 1,981 | 55,666 | 6,981 | 101,193 |

28. Cont'd

**At 31 December 2014**

| | Assets | Notional values related to assets | Liabilities | Notional values related to liabilities |
|---|---|---|---|---|
| Interest rate swaps | 360 | 10,800 | 1,027 | 18,950 |
| Cross currency interest rate swaps | 886 | 34,369 | 1,926 | 24,252 |
| Equity forwards | 144 | 1,605 | 117 | 1,482 |
| Foreign exchange forwards | 16 | 1,468 | 97 | 3,695 |
| Foreign exchange swaps | 306 | 4,744 | 2 | 963 |
| Bond forwards | 98 | 4,371 | 15 | 1,100 |
| Bond options | - | - | 93 | 25,000 |
| **Derivatives** | 1,810 | 57,357 | 3,277 | 75,442 |
| Short positions in listed bonds | - | - | 686 | - |
| **Total** | 1,810 | 57,357 | 3,963 | 75,442 |

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

Short positions are in Icelandic government bonds and institutions with government guarantees. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

## Loans and receivables

29. Loans to credit institutions:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Money market loans | 3,888 | 10,889 |
| Bank accounts | 31,646 | 24,183 |
| **Loans to credit institutions** | 35,534 | 35,072 |

30. Loans to customers - impairment allowance per sector:

**At 31 December 2015**

| | Gross amount | Specific impairment allowance | Loans less impairment allowance |
|---|---|---|---|
| Loans to customers: | | | |
| Individuals | 276,053 | ( 3,443) | 272,610 |
| Commerce and services | 90,956 | ( 1,175) | 89,781 |
| Construction | 24,815 | ( 1,802) | 23,013 |
| Energy | 3,737 | - | 3,737 |
| Financial services | 105 | - | 105 |
| Industrial and transportation | 63,589 | ( 2,863) | 60,726 |
| Investment companies | 21,643 | ( 2,281) | 19,362 |
| Public sector and non-profit organisations | 13,878 | - | 13,878 |
| Real estate | 99,869 | ( 775) | 99,094 |
| Seafood | 86,938 | ( 1,066) | 85,872 |
| Loans to customers before collective impairment allowance | | | 668,178 |
| Collective impairment allowance | | | ( 2,467) |
| **Loans to customers** | 681,583 | ( 13,405) | 665,711 |

30. Cont'd

**At 31 December 2014**

| | Gross amount | Specific impairment allowance | Loans less impairment allowance |
|---|---|---|---|
| Loans to customers: | | | |
| Individuals | 268,053 | ( 5,205) | 262,848 |
| Commerce and services | 83,590 | ( 3,932) | 79,658 |
| Construction | 21,472 | ( 2,721) | 18,751 |
| Energy | 7,315 | - | 7,315 |
| Financial services | 121 | - | 121 |
| Industrial and transportation | 63,019 | ( 1,141) | 61,878 |
| Investment companies | 15,531 | ( 1,620) | 13,911 |
| Public sector and non-profit organisations | 12,234 | ( 18) | 12,216 |
| Real estate | 100,774 | ( 1,234) | 99,540 |
| Seafood | 82,449 | ( 1,037) | 81,412 |
| Loans to customers before collective impairment allowance | | | 637,650 |
| Collective impairment allowance | | | ( 2,851) |
| **Loans to customers** | 654,558 | ( 16,908) | 634,799 |

31. Impairment

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

| | Specific impairment allowance | Collective impairment allowance | Total |
|---|---|---|---|
| At 1 January 2015 | 16,908 | 2,851 | 19,759 |
| Amounts written-off | ( 6,699) | - | ( 6,699) |
| Recoveries of amounts previously written-off | 591 | - | 591 |
| Principal credit adjustment | ( 461) | - | ( 461) |
| Charged to the income statement | 3,567 | ( 383) | 3,184 |
| Other | ( 501) | - | ( 501) |
| **At 31 December 2015** | 13,405 | 2,467 | 15,873 |

| | Specific impairment allowance | Collective impairment allowance | Total |
|---|---|---|---|
| At 1 January 2014 | 24,234 | 3,682 | 27,915 |
| Reclass 1 January | ( 137) | 137 | - |
| Amounts written-off | ( 9,745) | - | ( 9,745) |
| Recoveries of amounts previously written-off | 934 | - | 934 |
| Principal credit adjustment | ( 1,200) | - | ( 1,200) |
| Charged to the income statement | 2,822 | ( 967) | 1,855 |
| **At 31 December 2014** | 16,908 | 2,851 | 19,759 |

# Notes to the Consolidated Financial Statements

## Investments in associates

32. Changes in investments in associates:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Investments in associates at the beginning of the year | 570 | 1,563 |
| Additions during the period | 33 | 62 |
| Share of results | 63 | 27 |
| Dividends paid | 23 | - |
| Distribution of capital | - | ( 1,062) |
| Other | 27 | ( 20) |
| **Investments in associates** | 716 | 570 |

33. The Group's interest in its principal associates are as follows:

| | Ownership 31.12.2015 | Ownership 31.12.2014 |
|---|---|---|
| FAST GP ehf., Kirkjusandi 2, 155 Reykjavík | 35.0% | 35.0% |
| Atorka Group hf., Túngötu 14, 101 Reykjavík | 26.8% | 26.8% |
| Reiknistofa bankanna hf., Katrínartúni 2, 105 Reykjavík | 30.8% | 30.8% |
| Audkenni hf., Borgartúni 31, 105 Reykjavík | 22.4% | 20.9% |

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

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Total assets | 5,172 | 8,644 |
| Total liabilities | ( 2,284) | ( 5,352) |
| Net assets | 2,888 | 3,292 |
| **Group's share of net assets of associates** | 716 | 570 |

| | 2015 | 2014 |
|---|---|---|
| Total revenue | 4,605 | 4,620 |
| Total loss of associates for the year | ( 613) | ( 1,232) |

## Investment in subsidiaries

34. Significant subsidiaries:

| | Location | Ownership 31.12.2015 | Ownership 31.12.2014 |
|---|---|---|---|
| Borgun hf., Ármúla 30, 108 Reykjavík | Iceland | 63.5% | 63.5% |
| Íslandssjódir hf., Kirkjusandi 2, 155 Reykjavík | Iceland | 100% | 100% |
| Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur | Iceland | 100% | 100% |
| Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur | Iceland | 100% | 100% |
| D-1 ehf., Kirkjusandi 2, 105 Reykjavík | Iceland | 100% | 100% |
| 22 other subsidiaries (SME) | | | |

# Notes to the Consolidated Financial Statements

35. Non-controlling interests ("NCI") in subsidiaries

The following table summarises the infomation relating to the Group's subsidiary that has material NCI.

Borgun hf.

| | | |
|---|---|---|
| Non-controlling interests percentage | 36.5% | 36.5% |
| | 2015 | 2014 |
| Loans and receivables | 4,329 | 4,118 |
| Other assets | 31,411 | 24,818 |
| Liabilities | 25,206 | 24,571 |
| **Net assets** | 10,534 | 4,365 |
| Carrying amount of NCI | 3,845 | 1,593 |
| Revenue | 4,674 | 4,212 |
| Profit | 1,523 | 1,316 |
| Other comprehensive income for the year, net of tax | 5,445 | - |
| **Total comprehensive income** | 6,968 | 1,316 |
| Profit allocated to NCI | 2,543 | 480 |
| Cash flows from operating activities | 1,490 | 3,300 |
| Cash flows from investing activities | ( 574) | ( 485) |
| Cash flows from financing activities | ( 800) | - |
| **Net increase in cash and cash equivalents** | 116 | 2,815 |

Borgun paid out ISK 800 million in dividends to its shareholders in the year 2015.

# Notes to the Consolidated Financial Statements

## Related party disclosures

36. Ultimate controlling party

The Group has determined that ISB Holding ehf. is the ultimate controlling party of the Group with GLB Holding ehf. and Glitnir hf. having significant influence. This is in accordance with the definition of a related party in IAS 24 Related party disclosures and is reflected in the related party transactions.

The Icelandic State Treasury owns 5% of the Group's shareholding through the Icelandic State Financial Investments (ISFI). 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 Group's transactions with state-controlled entities during the period were based on general business terms and are therefore not considered to be related party transactions.

In the end of January 2016 Glitnir signed an agreement to deliver the estate's stability contribution to the Central Bank of Iceland and the Icelandic Government. A portion of the stability contribution is Glitnir's 95% stake in Íslandsbanki. The Bank is expected to be fully government owned by the end of Q1 2016. This change is subject to the approval of the Competition Authority, and the transfer of ownership will not take place until such approval has been obtained.

Cash and balances with the Central Bank are disclosed under Note 27 and Deposits from Central Bank are disclosed under Note 41.

Related party transactions

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

All loans to employees are provided on general business terms of the Group. The balances do not reflect collaterals held by the Group.

Related parties have transacted with the Group as follows:

**At 31 December 2015**

| Balance with related parties: | Assets | Liabilities | Net balance | Guarantees | Commitments and overdraft |
|---|---|---|---|---|---|
| Shareholders with control over the Group | - | ( 110) | ( 110) | - | - |
| Board of Directors and key management personnel | 359 | ( 563) | ( 204) | - | 67 |
| Associated companies and other related parties | 533 | ( 479) | 54 | - | 228 |
| **Balance with related parties** | 892 | ( 1,152) | ( 260) | - | 295 |

| Transactions with related parties: | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | - | ( 4) | - | - |
| Board of Directors and key management personnel | 22 | ( 18) | 3 | - |
| Associated companies and other related parties | 37 | ( 37) | 43 | - |
| **Transactions with related parties** | 59 | ( 59) | 46 | - |

**At 31 December 2014**

| Balance with related parties: | Assets | Liabilities | Net balance | Guarantees | Commitments and overdraft |
|---|---|---|---|---|---|
| Shareholders with control over the Group | - | ( 147) | ( 147) | - | - |
| Board of Directors and key management personnel | 430 | ( 611) | ( 181) | 27 | 77 |
| Associated companies and other related parties | 553 | ( 1,316) | ( 763) | 435 | 26 |
| **Balance with related parties** | 983 | ( 2,074) | ( 1,091) | 462 | 103 |

| Transactions with related parties: | Interest income | Interest expense | Other income | Other expense |
|---|---|---|---|---|
| Shareholders with control over the Group | - | ( 111) | - | - |
| Board of Directors and key management personnel | 1,573 | ( 29) | 1,167 | - |
| Associated companies and other related parties | 47 | ( 29) | 26 | - |
| **Transactions with related parties** | 1,620 | ( 169) | 1,193 | - |

Impairment allowances of ISK -1 million (2014: ISK -165 million) were recognised during the year against balances outstanding with associated companies. No share option programmes were operated during 2015. For related party remuneration see Note 20.

# Notes to the Consolidated Financial Statements

## Property and equipment

37. Property and equipment are specified as follows:

| At 31 December 2015 | Land and buildings | Fixtures, equipment & vehicles | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 6,753 | 4,533 | 11,286 |
| Additions during the year | 169 | 574 | 743 |
| Disposals and write-offs during the year | ( 135) | ( 224) | ( 359) |
| **Balance at 31.12.2015** | 6,787 | 4,883 | 11,670 |
| **Accumulated depreciation** | | | |
| Balance at the beginning of the year | ( 1,440) | ( 2,444) | ( 3,884) |
| Depreciation during the year | ( 109) | ( 507) | ( 616) |
| Disposals and write-offs during the year | 10 | 164 | 174 |
| **Balance at 31.12.2015** | ( 1,539) | ( 2,787) | ( 4,326) |
| **Carrying amount at 31.12.2015** | 5,248 | 2,096 | 7,344 |
| Depreciation rates | 0-2% | 8-33% | |

| | |
|---|---|
| Official real estate value of buildings and land | 4,076 |
| Insurance value of buildings as at 31.12.2015 | 5,929 |
| Insurance value of fixtures, equipment and vehicles as at 31.12.2015 | 2,261 |

| At 31 December 2014 | Land and buildings | Fixtures, equipment & vehicles | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 7,843 | 4,402 | 12,245 |
| Additions during the year | 376 | 382 | 758 |
| Disposals and write-offs during the year | ( 1,466) | ( 251) | ( 1,717) |
| **Balance at 31.12.2014** | 6,753 | 4,533 | 11,286 |
| **Accumulated depreciation** | | | |
| Balance at the beginning of the year | ( 1,386) | ( 2,087) | ( 3,473) |
| Depreciation during the year | ( 120) | ( 512) | ( 632) |
| Disposals and write-offs during the year | 66 | 155 | 221 |
| **Balance at 31.12.2014** | ( 1,440) | ( 2,444) | ( 3,884) |
| **Carrying amount at 31.12.2014** | 5,313 | 2,089 | 7,402 |
| Depreciation rates | 0-2% | 8-33% | |

| | |
|---|---|
| Official real estate value of buildings and land | 4,091 |
| Insurance value of buildings as at 31.12.2014 | 5,848 |
| Insurance value of fixtures, equipment and vehicles as at 31.12.2014 | 2,300 |

# Notes to the Consolidated Financial Statements

## Intangible assets

38. Intangible assets are specified as follows:

| At 31 December 2015 | Purchased software | Developed software | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 940 | 202 | 1,142 |
| Additions during the year and internal development | 574 | 274 | 848 |
| **Balance at 31.12.2015** | 1,514 | 476 | 1,990 |
| **Accumulated amortisation** | | | |
| Balance at the beginning of the year | ( 340) | ( 183) | ( 523) |
| Amortisation during the year | ( 118) | ( 18) | ( 136) |
| **Balance at 31.12.2015** | ( 458) | ( 201) | ( 659) |
| **Carrying amount at 31.12.2015** | 1,056 | 275 | 1,331 |
| Amortisation rates | 25% | 25% | |

| At 31 December 2014 | Purchased software | Developed software | Total |
|---|---|---|---|
| **Historical cost** | | | |
| Balance at the beginning of the year | 478 | 200 | 678 |
| Additions during the year and internal development | 462 | 2 | 464 |
| **Balance at 31.12.2014** | 940 | 202 | 1,142 |
| **Accumulated amortisation** | | | |
| Balance at the beginning of the year | ( 246) | ( 133) | ( 379) |
| Amortisation during the year | ( 94) | ( 50) | ( 144) |
| **Balance at 31.12.2014** | ( 340) | ( 183) | ( 523) |
| **Carrying amount at 31.12.2014** | 600 | 19 | 619 |
| Amortisation rates | 25% | 25% | |

## Other assets

39. Other assets are specified as follows:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Receivables | 4,166 | 4,845 |
| Unsettled securities transactions | 1,279 | 1,660 |
| Accruals | 616 | 606 |
| Prepaid expenses | 265 | 213 |
| Deferred tax assets | 21 | 521 |
| Other assets | 327 | 295 |
| **Other assets** | 6,674 | 8,140 |

# Notes to the Consolidated Financial Statements

## Non-current assets and disposal groups held for sale

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

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Repossessed collateral | 5,471 | 8,592 |
| Assets of disposal groups classified as held for sale | 7,321 | 13,057 |
| **Total** | 12,792 | 21,649 |

Repossessed collateral:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Land and property | 5,427 | 8,176 |
| Industrial equipment and vehicles | 44 | 51 |
| Shares and equity instruments | - | 365 |
| **Total** | 5,471 | 8,592 |

The Group classified on 31 December 2015 the assets and liabilities of its subsidiaries Fastengi ehf. (100%), Hafnargata 7 ehf. (100%), IG Invest ehf. (71.1%), Smyrlaheidi ehf. (100%), LT lódir ehf. (100%), Geysir Green Investment Fund slhf. (100%), Gráhella ehf. (100%), ÍSB fasteignir ehf. (100%), Fergin ehf. (80%), and Frumherji hf. (80%) as assets and liabilities of disposal groups held for sale.

Shares and equity instruments comprise shares in the Group's associates and are classfied as non-current assets held for sale.

The income tax expense for discontinued operation amounted to ISK 257 million in the year 2015.

Assets of disposal groups classified as held for sale:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Cash | 592 | 150 |
| Equity instruments | 775 | 775 |
| Receivables | 1,378 | 1,050 |
| Property and land | 2,044 | 6,820 |
| Equipment | 178 | 411 |
| Other assets | 2,354 | 3,851 |
| **Total** | 7,321 | 13,057 |

Liabilities associated with assets and disposal groups classified as held for sale:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Payables | 77 | 80 |
| Tax liabilities | 325 | 121 |
| Borrowings | 2,299 | 2,284 |
| Other liabilities | 124 | 305 |
| **Total** | 2,825 | 2,790 |

On 31 May 2015 the Group sold 100% of its shareholding in Bréfabær ehf., Fjárvari ehf. and Sævarhöfdi ehf. On 1 October 2015 the Group sold 100% of its shareholding in Manston Properties Ltd .The entities were classified as disposal groups held for sale. The Group has derecognised the assets and liabilities and other components related to the subsidiaries. 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".

# Notes to the Consolidated Financial Statements

## Deposits from Central Bank and credit institutions

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

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Repurchase agreements with Central Bank | 97 | 69 |
| Deposits from credit institutions | 25,534 | 25,727 |
| **Deposits from Central Bank and credit institutions** | 25,631 | 25,796 |

## Deposits from customers

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

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Demand deposits | 485,128 | 421,332 |
| Time deposits | 108,117 | 108,115 |
| **Deposits from customers** | 593,245 | 529,447 |

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

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

| | | 31.12.2015 | | 31.12.2014 |
|---|---|---|---|---|
| | Amount | % of total | Amount | % of total |
| Central government and state-owned enterprises | 9,274 | 2% | 11,437 | 2% |
| Municipalities | 4,598 | 1% | 4,428 | 1% |
| Other companies | 364,651 | 61% | 312,699 | 59% |
| Individuals | 214,722 | 36% | 200,883 | 38% |
| **Deposits from customers** | 593,245 | 100% | 529,447 | 100% |

## Pledged assets

44. Pledged assets against liabilities:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Financial assets which have been pledged as collateral against liabilities | 107,865 | 95,686 |
| Financial assets which has been pledged as collateral in foreign banks | 578 | 947 |
| **Pledged assets against liabilities** | 108,443 | 96,633 |

The Group 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 Group also pledged a pool of customer loans as collateral for an asset-backed bond issued to the Central Bank.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

## Debt issued and other borrowed funds

45. Specification of debt issued and other borrowed funds:

| | Issued | Maturity | Maturity type | Terms of interest | 31.12.2015 | 31.12.2014 |
|---|---|---|---|---|---|---|
| Covered bond in ISK | 2012-2013 | 2015 | At Maturity | Fixed, 6.398% | - | 4,536 |
| Covered bond in ISK | 2013-2014 | 2016 | At Maturity | Fixed, 6.2523% | 2,852 | 2,770 |
| Covered bond in ISK | 2014-2015 | 2019 | At Maturity | Fixed, 6.9299% | 4,158 | 1,424 |
| Covered bond in ISK | 2015 | 2023 | At Maturity | Fixed 6.40% | 5,559 | - |
| Covered bond in ISK - CPI linked | 2011 | 2016 | At Maturity | Fixed, CPI linked, 3.50% | 4,421 | 4,336 |
| Covered bond in ISK - CPI linked | 2012-2014 | 2019 | At Maturity | Fixed, CPI linked, 2.84% | 8,362 | 7,958 |
| Covered bond in ISK - CPI linked | 2014-2015 | 2020 | At Maturity | Fixed, CPI linked, 3.4699% | 3,968 | 1,939 |
| Covered bond in ISK - CPI linked | 2015 | 2022 | At Maturity | Fixed, CPI linked, 2.98% | 2,836 | |
| Covered bond in ISK - CPI linked | 2012-2014 | 2024 | At Maturity | Fixed, CPI linked, 3.45% | 11,113 | 10,356 |
| Covered bond in ISK - CPI linked | 2015 | 2026 | At Maturity | Fixed, CPI linked, 3.372% | 6,408 | - |
| **Covered bonds** | | | | | 49,677 | 33,319 |
| Senior unsecured bond in SEK | 2013, 2014 | 2017 | At Maturity | Floating, STIBOR + 4.00% | 12,359 | 13,212 |
| Senior unsecured bond in EUR * | 2014 | 2016 | At Maturity | Fixed, 3.00% | 7,449 | 15,572 |
| Senior unsecured bond in SEK | 2015 | 2019 | At Maturity | Floating, STIBOR + 3.10% | 9,280 | - |
| Senior unsecured bond in EUR | 2015 | 2018 | At Maturity | Fixed, 2.875% | 32,018 | - |
| Senior unsecured bond in NOK | 2015 | 2018 | At Maturity | Floating, NIBOR + 2.60% | 7,365 | - |
| **Bonds issued** | | | | | 68,471 | 28,784 |
| Central Bank secured bond in ISK | | | | | 19,732 | 24,505 |
| Bills issued | | | | | 9,992 | 4,356 |
| Non-listed issued bonds | | | | | - | 3,306 |
| Loans from credit institutions | | | | | 2 | 2 |
| Other debt securities | | | | | 2,434 | 2,617 |
| **Other loans / bills** | | | | | 32,160 | 34,786 |
| **Debt issued and other borrowed funds** | | | | | 150,308 | 96,889 |

* Íslandsbanki repurchased own debt during the year for the amount of EUR 47.7 million (equivalent to ISK 6,794 million) and ISK 520 million of covered bonds, total ISK 7,314 million with minor effects on the consolidated income statement.

The covered bond amounts do not contain the bonds reserved for securities lending.

The Group has not had any defaults of principal, interest or other breaches with respect to its debt issued and other borrowed funds.

# Notes to the Consolidated Financial Statements

## Subordinated loans

46. Specification of subordinated loans:

| | Issued | Currency | Maturity date | Book value 31.12.2015 | Book value 31.12.2014 |
|---|---|---|---|---|---|
| Loans which qualify as Tier 2 capital: | | | | | |
| Subordinated loans - unlisted | 2009 | EUR | 31.12.2019 | 19,517 | 21,306 |
| **Subordinated loans** | | | | 19,517 | 21,306 |

In 2015 the interest rate was 4.96% (2014: 4.1%).

Subordinated loans consist of a Tier 2 bond of EUR 138 million.

Subordinated loans are financial liabilities of the Group which consist of liabilities in the form of subordinated loan capital which, in case of the Group'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 2. 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 2 issue matures, the regulator demands that the subordinated issue is subjected to a progressive discount, of 20% per annum, for Tier 2 capital purposes during the last five years of its maturity.

## Tax assets and tax liabilities

47. Tax in the balance sheet:

| | 31.12.2015 | | 31.12.2014 | |
|---|---|---|---|---|
| | Assets | Liabilities | Assets | Liabilities |
| Current tax | - | 8,045 | - | 8,386 |
| Deferred tax | 21 | 313 | 521 | 2 |
| **Tax in the balance sheet** | 21 | 8,358 | 521 | 8,388 |

48. Changes in the deferred tax assets and the tax liabilities during the year were as follows:

| | Assets | Liabilities |
|---|---|---|
| Deferred tax assets and tax liabilities 1.1.2014 | 1,275 | 20 |
| Calculated income tax for 2014 | ( 5,331) | 67 |
| Income tax payable in 2015 | 4,659 | ( 66) |
| Prior year income tax adjustment | ( 82) | ( 19) |
| **Deferred tax assets and tax liabilities 31.12.2014** | 521 | 2 |
| Transferred deferred tax assets to deferred tax liabilities 1.1.2015 | (507) | (507) |
| Calculated income tax for 2015 | ( 401) | 4,456 |
| Income tax payable in 2016 | 408 | ( 3,753) |
| Prior year income tax adjustment | - | 115 |
| **Deferred tax assets and tax liabilities 31.12.2015** | 21 | 313 |

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

| 2015 | Net balance at 1 January | Recognised in profit or (loss) | Balance at 31 December Net | Deferred tax assets | Deferred tax liabilities |
|---|---|---|---|---|---|
| Property and equipment | ( 204) | 7 | ( 197) | 19 | ( 216) |
| Assets and liabilities denominated in foreign currency | ( 187) | ( 31) | ( 218) | - | ( 218) |
| Other intangible assets | 693 | ( 774) | ( 81) | - | ( 81) |
| Deferred foreign exchange difference | 217 | ( 12) | 205 | 205 | - |
| Tax loss carry forwards | - | ( 1) | ( 1) | - | ( 1) |
| | 519 | ( 811) | ( 292) | 224 | ( 516) |
| Set-off of deferred tax assets together with liabilities of the same taxable entities | | | | ( 203) | 203 |
| **Tax assets (liabilities)** | 519 | ( 811) | ( 292) | 21 | ( 313) |

| 2014 | Net balance at 1 January | Recognised in profit or (loss) | Balance at 31 December Net | Deferred tax assets | Deferred tax liabilities |
|---|---|---|---|---|---|
| Property and equipment | ( 212) | 8 | ( 204) | - | ( 204) |
| Assets and liabilities denominated in foreign currency | ( 156) | ( 31) | ( 187) | - | ( 187) |
| Other intangible assets | 1,433 | ( 740) | 693 | 693 | - |
| Deferred foreign exchange difference | 127 | 90 | 217 | 218 | ( 1) |
| Tax loss carry forwards | 63 | ( 63) | - | - | - |
| | 1,255 | ( 736) | 519 | 911 | ( 392) |
| Set-off of deferred tax assets together with liabilities of the same taxable entities | | | | (390) | 390 |
| **Tax assets (liabilities)** | 1,255 | ( 736) | 519 | 521 | ( 2) |

# Notes to the Consolidated Financial Statements

## Other liabilities

50. Specification of other liabilities:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Accruals | 3,632 | 3,250 |
| Liabilities to retailers for credit card | 23,869 | 22,639 |
| Provision for effects of court rulings* | 1,665 | 2,808 |
| Provision for estimated losses from guarantees and others** | 207 | 1,629 |
| Withholding tax | 2,072 | 1,623 |
| Unsettled securities transactions | 1,698 | 1,798 |
| Deferred income | 130 | 192 |
| Sundry liabilities | 3,404 | 3,323 |
| **Other liabilities** | 36,677 | 37,262 |

| Provision: | Provision for effects of court rulings* | Provision for estimated losses from guarantees and others** | Total |
|---|---|---|---|
| At 1 January 2015 | 2,808 | 1,629 | 4,437 |
| Provision used during the year | ( 1,143) | - | ( 1,143) |
| New provisions and reversed provisions during the year | - | ( 1,422) | ( 1,422) |
| **At 31 December 2015** | 1,665 | 207 | 1,872 |

## Equity

51. Share capital

Authorised share capital of the Group is 10,000 million ordinary shares of ISK 1 each. At 31.12.2015 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Group.

Issued share capital:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Ordinary fully paid shares of ISK 1 krona each | 10,000 | 10,000 |
| **Share capital** | 10,000 | 10,000 |

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

Share premium account:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Premium arising on issue of equity shares | 55,000 | 55,000 |
| **Share premium** | 55,000 | 55,000 |

Total share capital:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Ordinary share capital | 10,000 | 10,000 |
| Share premium | 55,000 | 55,000 |
| **Total share capital** | 65,000 | 65,000 |

# Notes to the Consolidated Financial Statements

52. Other reserves are specified as follows:

| | Other reserves |
|---|---|
| Other reserves as at 1.1.2014 | 2,471 |
| Translation differences | 64 |
| Fair value changes of financial assets available for sale | - |
| **Other reserves as at 31.12.2014** | 2,535 |
| Translation differences | 9 |
| Fair value changes of financial assets available for sale | 3,458 |
| **Other reserves as at 31.12.2015** | 6,002 |

## Operating lease commitments

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

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Up to 1 year | 240 | 240 |
| 1-5 years | 661 | 760 |
| Later than 5 years | 391 | 493 |
| **Operating lease commitments** | 1,292 | 1,493 |

The Group 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.

## Custody assets

54. Custody assets:

| | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Custody assets | 665,046 | 666,715 |

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

## Contingencies

55. Contingencies

*Provisions*

**Foreign currency-linked loan contracts**

The Supreme Court of Iceland has made several rulings starting in 2010 when many foreign currency-linked loan contracts were found to be in violation of the 2001 law on interest and indexation. Several rulings found no fault in other contract forms, including the most common type of mortgage contract. The combined court rulings to date have greatly reduced the uncertainty relating to these contracts and how they should be recalculated. The Group's corrective process concerning the affected loan contracts is in its final stages, the last ones being corporate finance lease contracts.

The majority of the nine remaining court cases concern foreign currency-linked loan contracts with minor deviations in terms from those which have already repeatedly been ruled to be legal contracts. Most of these cases will be closed in the District Courts and the Supreme Court in 2016, but a few will not be concluded until the first quarter of 2017. However, as some of the cases involve similar contracts, precedent could result in other cases being settled out of court. The Group considers it unlikely that these rulings will set any significant precedent as far as other loan contracts are concerned. The Group therefore considers the likelihood of having to perform another round of mass-recalculation of foreign currency-linked loan contracts to be remote.

The effect of these court rulings and the subsequent recalculation of loan contracts is reflected in the value of loans in the Group's consolidated financial statements as at 31 December 2015 where the Group has recognised a total provision of ISK 1,665. (see Note 50).

# Notes to the Consolidated Financial Statements

55. Cont'd

*Contingent liabilities*

**Variable rate loan contracts**

In September 2014, the Consumer Appellate Committee (the “Committee”) published its decision on a matter regarding the terms of, and information relating to the granting of, a consumer mortgage contract with interest reset terms granted by the Group in 2005. The Committee found the terms offered by the Group and its predecessor, regarding the method and conditions of resetting interest rates, to be in breach of Articles 6 and 9 of Act no. 121/1994 on Consumer Credit (superseded in November 2013). The Committee found the terms to be insufficient as to the explanation of how or what can affect the decision for the interest rate being revised. A 2009 Committee decision was quoted as a precedent. Subsequent to the Agency's decision, the Group decided to postpone a scheduled interest rate reset and customers were given the option to have their loans restructured with appropriate documentation, fully adapted to the new law on consumer credit.

The Group has stated officially that it disagrees with the Committee's decision in that the law requires a more detailed explanation with regards to the outcome from a reset of interest rates. The terms explicitly state the time period during which the Group can reset the interest rate and, moreover, that the borrower can settle the loan without a pre-settlement charge if he is not content with the terms. The 2009 precedent referred to by the Committee did not involve pre-settlement terms. Article 12 of the former Act on Consumer Credit stipulates that in the cases of credit contracts containing clauses allowing variations in the rate of interest and the amount or level of other charges contained in the annual percentage rate of charge (APR), but unquantifiable at the time when the payment schedule is presented, the APR shall be calculated on the assumption that the price level, interest rate and other charges will remain unchanged until the end of the credit agreement. The Group's payment schedule accordingly states that the schedule is based on the current Consumer Price Index ("CPI") and the interest rates and service charges in effect at the Group at the time of issuance. Similar terms were applied by all major financial institutions serving the mortgage loan market at the time, including the Housing Financing Fund.

The Group has referred the matter to the courts. The court proceedings are expected to be concluded in late 2016. The consequences of an adverse outcome for the Group are not easily quantifiable. At present, the Group has not recognised any provision against a possible loss due to this litigation. In part this is due to the fact that early payments and refinancing is rapidly decreasing the number of contracts in question.

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

The Icelandic Competition Authority ("ICA") has initiated an investigation concerning alleged violations of the Competition Law no. 44/2005 by the Group. Details of the investigation remain confidential.

The ICA has requested and received information from the Group and has, following its review, presented an opposition document. The ICA considers the violations to be extensive, to have been in existence for a considerable period and to concern important markets. The opposition document is one stage in the processing of the case and does not comprise a final administrative decision.

The Group strongly disagrees with the ICA's findings and has presented its objections. However, should the ICA's findings be final, sanctions may come into consideration, in accordance with Article 37 of the Competition Act. The Group has not recognised a provision in relation to this matter.

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

On 22 October 2013, the EFTA Surveillance Authority ("ESA"), following a complaint, formally requested information on alleged unlawful state aid granted to the Group through long-term funding at favourable interest rates by the Central Bank of Iceland. The funding was in the form of an ISK 55 billion bond with a ten-year tenure, issued by The Group and placed with the Central Bank. It is alleged that the funding was provided on terms more favourable than the then current market terms.

The Icelandic authorities and the Group have sent all relevant information and their observations as per the ESA request, in order to determine whether or not the measures involve state aid based on the interpretation of Article 61 of the European Economic Area ("EEA") Agreement, or if they qualify for an exemption under Article 61(2) or (3). Both parties, the Group and the Icelandic authorities, state that the measures cannot be considered state aid within the meaning of Article 61(1), as the funding in question was provided at what has to be considered market rates at the time and were indeed favourable to the Central Bank. However, should the ESA disagree, the measures must be considered state aid compatible with the functioning of the EEA Agreement under Article 61(3) (b) and the Group may have to reimburse the Central Bank with an amount equal to the difference between market terms and the terms of the Bond. The Group has not recognised a provision in relation to this matter.

**The Depositors' and Investors' Guarantee Fund**

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

# Notes to the Consolidated Financial Statements

55. Cont'd

*Contingent assets*

**Settlement of the 2011 Byr acquisition**

The Group acquired Byr hf. ("Byr"), a former savings bank, in 2011 from the Byr Winding-up Committee ("Committee") and the Icelandic Ministry of Finance and Economic Affairs ("Ministry"). According to standard practice, the Group retained the right to re-evaluate the fair value of the net assets acquired and to demand a refund if the fair value of the net assets was not in line with what was presented in the Byr's financial statements. Based on this, the Group filed a claim amounting to ISK 6,943 million plus interest with the Committee in June 2013. The claim is filed as a priority claim, according to Article 110 of the Act on Bankruptcy no. 21/1991 The Committee rejected the claim with a letter dated 30 September 2013. At a creditors' meeting in December 2013 it was decided that the Committee would refer the dispute to the District Court of Reykjavík. A formal claim amounting to ISK 911 million plus interest was filed with the Ministry on 24 September 2014. Both claims have now been filed with the District Court of Reykjavík. Furthermore, at the request of the Group, the District Court has appointed two independent professionals to perform a formal evaluation of the Group's claim on the Ministry and the Committee. The evaluation is expected to be completed before the second quarter of 2016. Court proceedings are expected to commence in the second or third quarter of 2016. The Group has not recognised any revenues relating to this claim.

The District Court of Reykjavík confirmed the Composition Agreement of Byr Savings Bank on January 8 2016. The Agreement includes reservations due to Íslandsbanki's claim and is not expected to impact the proceedings described above.

*Other*

**Indexed loans**

On the 13 May 2015, the Supreme Court ruled on a case involving the fixing of the principal of a mortgage contract to the Consumer Price Index (CPI). The plaintiff argued that by using in the payment schedule and the Annual Percentage Rate of Charge (APRC) an assumption of a zero-percent rate of inflation, the Group was in violation of the European Union ("EU") Directive 93/13/EU ("Directive"). The case was granted a simple and speedy process because it only involved an enforcement dispute. The Court upheld a previous decision of the District Court which ruled in favour of the Group, based mostly on the same arguments. As to the question of the use of zero-inflation, the Court acknowledged that some discrepancies were evident when the local law was adapted to the Directive on consumer loans in 1994. Despite the fact that Icelandic law should be interpreted as close to the EU/EEA law as possible, such an interpretation does not override the meaning derived from the wording of the Icelandic law which states that it is permissible to assume that the inflation will remain unchanged when calculating APRC in the payment schedule.

## Events after the balance sheet date

56. In the end of January 2016 Glitnir signed an agreement to deliver the estate's stability contribution to the Central Bank of Iceland and the Icelandic Government. A portion of the stability contribution is Glitnir's 95% stake in Íslandsbanki. The Government previously owned a 5% share in Íslandsbanki; therefore, the Bank is expected to be fully government owned by the end of Q1 2016. This change is subject to the approval of the Competition Authority, and the transfer of ownership will not take place until such approval has been obtained.

# Notes to the Consolidated Financial Statements

## Risk management

### 57. Risk governance

Íslandsbanki is exposed to various risk factors and managing these risks is an integral part of the Bank's operations. Risk governance within Íslandsbanki is based on a three lines of defence framework and aims for informed decision-making and strong risk awareness throughout the Bank.

The Bank's management body has a dual structure. The Board of Directors has a supervising role in monitoring the execution of set policies, the sound control of accounting and financial management and ensures that group internal audit, compliance and risk management are effective at all times. The Chief Executive Officer, the Chief Risk Officer, other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through the Bank's Risk Management and Internal Control Policy, the Risk Appetite Statement and other risk management policies.

The Chief Executive Officer (CEO) is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Bank's operations are consistent at all times with applicable legislation and the Bank's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer (CRO), the Compliance Officer as well as other members of the Executive Board, the Risk Committee, the Asset and Liability Committee and the Investment Committee.

The Chief Audit Executive (CAE) is appointed by the Board and directs Group Internal Audit by Board authorisation. The CAE is responsible for internal audit matters within the Bank, including outsourced projects. The Internal Audit is not responsible for internal control or its implementation, but provides the Bank with independent, objective assurance and consulting services designed to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of its risk management, controls, and governance processes.

The Compliance Officer a financial undertaking licensed to conduct securities trading and an issuer of listed financial instruments, the Bank operates a compliance department. The Bank's Compliance Officer is appointed by the CEO, subject to Board confirmation. The Compliance Officer is responsible for regular monitoring and assessment of the suitability and efficacy of the Bank's measures concerning securities transactions and anti-money laundering in accordance to Icelandic law.

The Chief Risk Officer (CRO) heads the Risk Management department and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for organising risk management within Íslandsbanki in order to ensure that Íslandsbanki has the right resources and an appropriate organisation to manage its risks efficiently. The CRO is a member of the Executive Board.

The CRO reports directly to the Board and cannot be removed without its prior approval. Regular reporting from the CRO to the Board includes an overview of compliance to risk limits and risk appetite, review of risk aspects inherent in the Bank's remuneration system and adequacy of risk based pricing of assets and liabilities.

Risk Management is independent from business lines but provides strategic support aligned with the Bank's business objectives. The existence of an independent risk management department does not absolve management from its responsibility as a first line of defence to identify and manage all risks arising in their business and function.

Risk Management is responsible for maintaining and developing internal directives and processes regarding risk management and internal control. The department organises training for the Bank's employees on the Bank's policies, internal directives and processes related to risk management and internal control. In addition, Risk Management provides the managers of business units with information and guidance regarding risk management and internal control issues.

Risk Management advises on risk and risk assessment. It develops, maintains and tests risk models and provides other forms of support within its expertise.

Risk Management reports on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

### 58. Risk management committee structure

The implementation of the risk management policies and internal controls in accordance with Board authorisation is delegated to the management committees: the Executive Board, the Risk Committee, the Asset and Liability Committee (ALCO), and the Investment Committee. Under this authorisation, these management committees issue guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite. The members of the management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter.

The Executive Board is responsible for the operational risk framework and governs the Bank's Operational Risk Policy. In addition, the Executive Board supervises reputational risk, business risk and strategic risk. The Executive Board approves concepts for new products and its approval is a prerequisite for product development according to the Bank's formal product approval process.

58. Cont'd

The Risk Committee is responsible for supervising and monitoring the Bank's credit risk and credit concentration risk. The Risk Committee governs the Bank's Credit Risk Policy and other credit rules and procedures. The Risk Committee can delegate authorisation power to subcommittees and decides on credit authorisation limits to individual employees.

The Risk Committee and each of its subcommittees have the authority to decide on credit proposals, credit risk and counterparty credit risk within defined limits. Decisions on exposures that exceed committee limits must be referred to a more senior committee. If credit decisions exceed the limit of the Risk Committee then the Board of Directors can grant increased authorisation limits for particular cases. As described above all credit proposals that are decided upon by the Risk Committee or its subcommittees are initiated, and the respective risk owned, by a business unit.

The Risk Committee is also responsible for final approval of products and services according to a formal product approval process within the Bank.

The Asset and Liability Committee (ALCO) supervises other financial risks, including market risk, liquidity risk and interest rate risk in the banking book (non-trading portfolio). ALCO decides on and sets limits for these risks and governs the Bank's Market Risk Policy and Liquidity Risk Policy. ALCO also oversees the Bank's capital allocation framework, the funding strategy and transfer pricing mechanism. The committee supervises the capital management framework, including the Internal Capital Adequacy Assessment Process (ICAAP) and the Pillar 2 Framework, and makes proposals to the Board regarding issues related to capital management and funding.

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 in investment funds and real estate, other than those originated in the trading book.

## Credit risk

59. 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 Group 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 Group'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 Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The 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 real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

60. **Maximum credit exposure**

The Group's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position before the collective impairment allowance is subtracted, see Note 30. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions the Group 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 Chapter 6 of the Regulation (EU) No. 575/2013 of the European Parliament.

The industry breakdown shows the Group'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 Group's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

## Credit risk exposure

60. Cont'd

Maximum credit exposure at 31 December 2015

| | Individuals | Central governments | Commerce and services | Construction | Energy | Financial services | Industrial and transportation | Investment companies | Public sector and non-profit organisations | Real estate | Seafood | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | - | 216,760 | - | - | - | - | - | - | - | - | - | 216,760 |
| Bonds and debt instruments | - | 72,876 | 1,530 | - | - | 3,067 | 306 | 506 | 16 | 304 | - | 78,605 |
| Derivatives | 5 | - | 23 | - | 1,208 | 3,073 | 22 | 15 | - | 13 | 53 | 4,412 |
| Loans to credit institutions | - | - | - | - | - | 35,534 | - | - | - | - | - | 35,534 |
| Loans to customers: | 272,610 | - | 89,781 | 23,013 | 3,737 | 105 | 60,726 | 19,362 | 13,878 | 99,094 | 85,872 | 668,178 |
| Overdrafts | 11,931 | - | 9,632 | 3,924 | 15 | 37 | 6,223 | 1,047 | 790 | 3,408 | 1,647 | 38,654 |
| Credit cards | 15,847 | - | 1,448 | 201 | 4 | 27 | 391 | 33 | 127 | 51 | 37 | 18,166 |
| Mortgages | 197,307 | - | - | - | - | - | - | - | - | - | - | 197,307 |
| Capital leases | 10,842 | - | 20,913 | 2,037 | 9 | 1 | 6,527 | 197 | 121 | 1,224 | 247 | 42,118 |
| Other loans | 36,683 | - | 57,788 | 16,851 | 3,709 | 40 | 47,585 | 18,085 | 12,840 | 94,411 | 83,941 | 371,933 |
| Other financial assets | 233 | 12 | 137 | 3 | 1 | 4,234 | 14 | 80 | 1 | 738 | 82 | 5,535 |
| Off-balance sheet items: | | | | | | | | | | | | |
| Financial guarantees | 1,406 | - | 3,445 | 2,592 | - | 1,668 | 1,831 | 52 | 29 | 219 | 363 | 11,605 |
| Undrawn loan commitments | - | - | 1,385 | 9,339 | 10,222 | - | 11,207 | 757 | - | 4,226 | 5,549 | 42,685 |
| Undrawn overdrafts | 9,636 | - | 9,007 | 1,834 | 209 | 3,198 | 3,103 | 404 | 2,482 | 1,595 | 1,663 | 33,131 |
| Credit card commitments | 25,360 | 2 | 3,677 | 520 | 36 | 169 | 998 | 162 | 802 | 227 | 162 | 32,115 |
| **Total maximum credit exposure** | 309,250 | 289,650 | 108,985 | 37,301 | 15,413 | 51,048 | 78,207 | 21,338 | 17,208 | 106,416 | 93,744 | 1,128,560 |

60. Cont'd

Maximum credit exposure at 31 December 2014

| | Individuals | Central governments | Commerce and services | Construction | Energy | Financial services | Industrial and transportation | Investment companies | Public sector and non-profit organisations | Real estate | Seafood | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with CB | - | 103,389 | - | - | - | - | - | - | - | - | - | 103,389 |
| Bonds and debt instruments | - | 79,834 | - | - | 291 | 5,785 | - | 890 | 251 | 296 | - | 87,347 |
| Derivatives | 28 | - | 423 | 17 | 805 | 2,644 | 28 | 16 | 121 | 49 | - | 4,131 |
| Loans to credit institutions | - | - | - | - | - | 35,072 | - | - | - | - | - | 35,072 |
| Loans to customers: | 262,848 | - | 79,658 | 18,751 | 7,315 | 121 | 61,878 | 13,911 | 12,216 | 99,540 | 81,412 | 637,650 |
| Overdrafts | 12,751 | - | 10,075 | 3,432 | 34 | 60 | 4,762 | 549 | 1,343 | 2,164 | 2,058 | 37,228 |
| Credit cards | 15,583 | - | 1,334 | 156 | 4 | 23 | 355 | 29 | 132 | 43 | 31 | 17,690 |
| Mortgages | 186,583 | - | - | - | - | - | - | - | - | - | - | 186,583 |
| Capital leases | 10,241 | - | 15,559 | 2,581 | - | 1 | 5,960 | 213 | 196 | 1,249 | 231 | 36,231 |
| Other loans | 37,690 | - | 52,690 | 12,582 | 7,277 | 37 | 50,801 | 13,120 | 10,545 | 96,084 | 79,092 | 359,918 |
| | | | | | | | | | | | | - |
| Other financial assets | 183 | - | 809 | 205 | 1 | 4,163 | 12 | 224 | 4 | 866 | 100 | 6,567 |
| Off-balance sheet items: | | | | | | | | | | | | |
| Financial guarantees | 1,444 | - | 2,318 | 2,281 | - | 1,170 | 1,134 | 39 | 39 | 166 | 533 | 9,124 |
| Undrawn loan commitments | - | - | 996 | 8,248 | 5,816 | - | 2,639 | 1,400 | 7,247 | 4,234 | 443 | 31,023 |
| Undrawn overdrafts | 9,216 | - | 7,459 | 1,618 | 23 | 3,673 | 2,561 | 187 | 1,874 | 975 | 1,361 | 28,947 |
| Credit card commitments | 23,183 | - | 3,455 | 477 | 31 | 167 | 906 | 166 | 818 | 197 | 144 | 29,544 |
| **Total maximum credit exposure** | 296,902 | 183,223 | 95,118 | 31,597 | 14,282 | 52,795 | 69,158 | 16,833 | 22,570 | 106,323 | 83,993 | 972,794 |

61. Credit exposure covered by collateral

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

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

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

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

| At 31 December 2015 | Real estate | Vessels | Cash & securities | Vehicles & equipment | Other collateral | Credit exposure covered by collateral |
|---|---|---|---|---|---|---|
| Derivatives | - | - | 3,181 | - | - | 3,181 |
| Loans and commitments to customers: | 425,053 | 78,274 | 6,416 | 38,604 | 42,650 | 590,997 |
| Individuals | 223,131 | 33 | 688 | 10,329 | 45 | 234,226 |
| Commerce and services | 46,418 | 422 | 344 | 19,902 | 8,719 | 75,805 |
| Construction | 20,856 | 154 | 208 | 1,953 | 2,360 | 25,531 |
| Energy | 2,895 | - | 414 | 9 | 88 | 3,406 |
| Financial services | 40 | - | 24 | 1 | - | 65 |
| Industrial and transportation | 23,776 | 6,208 | 411 | 5,797 | 10,765 | 46,957 |
| Investment companies | 5,056 | 10 | 3,460 | 91 | 7,524 | 16,141 |
| Public sector and non-profit organisations | 1,034 | - | 9 | 105 | - | 1,148 |
| Real estate | 96,805 | - | 572 | 207 | 562 | 98,146 |
| Seafood | 5,042 | 71,447 | 286 | 210 | 12,587 | 89,572 |
| **Total** | 425,053 | 78,274 | 9,597 | 38,604 | 42,650 | 594,178 |

| At 31 December 2014 | Real estate | Vessels | Cash & securities | Vehicles & equipment | Other collateral | Credit exposure covered by collateral |
|---|---|---|---|---|---|---|
| Derivatives | - | - | 2,500 | - | - | 2,500 |
| Loans and commitments to customers: | 391,139 | 74,032 | 5,991 | 33,473 | 24,174 | 528,809 |
| Individuals | 213,550 | 41 | 469 | 9,901 | 12 | 223,973 |
| Commerce and services | 40,484 | 290 | 472 | 14,525 | 8,838 | 64,609 |
| Construction | 13,217 | 269 | 59 | 2,473 | 1,592 | 17,610 |
| Energy | 1,260 | - | 411 | 1 | 152 | 1,824 |
| Financial services | 39 | - | 32 | 1 | - | 72 |
| Industrial and transportation | 16,487 | - | 148 | 5,760 | 7,914 | 30,309 |
| Investment companies | 4,973 | - | 3,434 | 248 | 2,642 | 11,297 |
| Public sector and non-profit organisations | 1,510 | - | 11 | 179 | - | 1,700 |
| Real estate | 94,859 | - | 650 | 143 | 564 | 96,216 |
| Seafood | 4,760 | 73,432 | 305 | 242 | 2,460 | 81,199 |
| **Total** | 391,139 | 74,032 | 8,491 | 33,473 | 24,174 | 531,309 |

62. Credit quality of financial assets

Loans are classified as impaired loans if there is objective evidence that an impairment loss has incurred. The carrying amount is then reduced through the use of an allowance account to the present value of expected future cash flows, discounted at the effective interest rate of the corresponding loans.

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

Further disclosure on past due but not impaired loans can be found in Note 64.

| At 31 December 2015 | Neither past due nor impaired | Past due but not impaired | Classified as impaired | Total carrying amount |
|---|---|---|---|---|
| Cash and balances with Central Bank | 216,760 | - | - | 216,760 |
| Bonds and debt instruments | 78,606 | - | - | 78,606 |
| Derivatives | 4,412 | - | - | 4,412 |
| Loans to credit institutions | 35,534 | - | - | 35,534 |
| Loans to customers: | 636,685 | 23,572 | 7,921 | 668,178 |
| Individuals | 253,798 | 15,443 | 3,369 | 272,610 |
| Commerce and services | 87,102 | 1,517 | 1,162 | 89,781 |
| Construction | 21,655 | 583 | 775 | 23,013 |
| Energy | 3,737 | - | - | 3,737 |
| Financial services | 65 | 40 | - | 105 |
| Industrial and transportation | 59,267 | 885 | 574 | 60,726 |
| Investment companies | 18,476 | 580 | 306 | 19,362 |
| Public sector and non-profit organisations | 13,839 | 39 | - | 13,878 |
| Real estate | 96,243 | 1,562 | 1,289 | 99,094 |
| Seafood | 82,503 | 2,923 | 446 | 85,872 |
| Other financial assets | 4,748 | 787 | - | 5,535 |
| **Total** | 976,745 | 24,359 | 7,921 | 1,009,025 |

| At 31 December 2014 | Neither past due nor impaired | Past due but not impaired | Classified as impaired | Total carrying amount |
|---|---|---|---|---|
| Cash and balances with Central Bank | 103,389 | - | - | 103,389 |
| Bonds and debt instruments | 87,347 | - | - | 87,347 |
| Derivatives | 4,131 | - | - | 4,131 |
| Loans to credit institutions | 35,072 | - | - | 35,072 |
| Loans to customers: | 595,903 | 27,619 | 14,128 | 637,650 |
| Individuals | 237,253 | 18,752 | 6,843 | 262,848 |
| Commerce and services | 75,572 | 2,253 | 1,833 | 79,658 |
| Construction | 17,319 | 914 | 518 | 18,751 |
| Energy | 7,315 | - | - | 7,315 |
| Financial services | 84 | 37 | - | 121 |
| Industrial and transportation | 60,295 | 881 | 702 | 61,878 |
| Investment companies | 12,500 | 766 | 645 | 13,911 |
| Public sector and non-profit organisations | 12,165 | 51 | - | 12,216 |
| Real estate | 96,905 | 1,969 | 666 | 99,540 |
| Seafood | 76,495 | 1,996 | 2,921 | 81,412 |
| Other financial assets | 6,424 | 143 | - | 6,567 |
| **Total** | 832,266 | 27,762 | 14,128 | 874,156 |

63. Neither past due nor impaired loans

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

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

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

The table below shows loans that are neither past due nor impaired aggregated in five customer groups based on the default probability. Group 1-4 represents low risk, group 5-6 moderate risk, group 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers in default. Unrated are loans originating from subsidiaries of Íslandsbanki that do not have rating models, in addition to loans that are yet to be rated or with an expired rating.

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

| | Risk class 1-4 | Risk class 5-6 | Risk class 7-8 | Risk class 9 | Risk class 10 | Unrated | Total |
|---|---|---|---|---|---|---|---|
| **At 31 December 2015** | | | | | | | |
| Loans to customers: | | | | | | | |
| Individuals | 11,793 | 99,967 | 91,329 | 44,290 | 2,418 | 4,001 | 253,798 |
| Commerce and services | 13,264 | 53,916 | 15,418 | 3,357 | 294 | 853 | 87,102 |
| Construction | 657 | 10,676 | 7,659 | 2,130 | 506 | 27 | 21,655 |
| Energy | 353 | 3,243 | 141 | - | - | - | 3,737 |
| Financial services | 36 | 9 | 20 | - | - | - | 65 |
| Industrial and transportation | 14,329 | 30,049 | 12,207 | 2,507 | 87 | 88 | 59,267 |
| Investment companies | 4,735 | 7,029 | 5,235 | 1,328 | 149 | - | 18,476 |
| Public sector and non-profit organisations | 5,605 | 8,048 | 175 | 3 | 7 | 1 | 13,839 |
| Real estate | 29,490 | 42,952 | 21,177 | 2,403 | 50 | 171 | 96,243 |
| Seafood | 36,848 | 33,065 | 11,372 | 327 | 892 | - | 82,504 |
| **Total** | 117,110 | 288,954 | 164,733 | 56,345 | 4,403 | 5,141 | 636,686 |

| | Risk class 1-4 | Risk class 5-6 | Risk class 7-8 | Risk class 9 | Risk class 10 | Unrated | Total |
|---|---|---|---|---|---|---|---|
| **At 31 December 2014** | | | | | | | |
| Loans to customers: | | | | | | | |
| Individuals | 10,432 | 91,744 | 84,838 | 43,101 | 3,659 | 3,479 | 237,253 |
| Commerce and services | 15,240 | 35,903 | 18,182 | 3,891 | 1,873 | 483 | 75,572 |
| Construction | 381 | 6,698 | 7,032 | 846 | 2,321 | 41 | 17,319 |
| Energy | 3,877 | 3,396 | 42 | - | - | - | 7,315 |
| Financial services | 50 | 13 | 19 | 1 | - | 1 | 84 |
| Industrial and transportation | 21,850 | 30,334 | 6,822 | 1,128 | 161 | - | 60,295 |
| Investment companies | 1,143 | 7,013 | 2,604 | 1,450 | 25 | 265 | 12,500 |
| Public sector and non-profit organisations | 7,094 | 4,815 | 248 | 6 | - | 2 | 12,165 |
| Real estate | 31,145 | 46,626 | 14,369 | 2,686 | 2,012 | 67 | 96,905 |
| Seafood | 39,777 | 28,171 | 6,176 | 746 | 1,625 | - | 76,495 |
| **Total** | 130,989 | 254,713 | 140,332 | 53,855 | 11,676 | 4,338 | 595,903 |

64. Past due but not impaired loans

Past due but not impaired loans are loans where contractual interest or principal payments have passed due date by more than 3 days without the obligor making full payment, but where specific impairment is not appropriate. The reason is usually that contractual payments are eventually expected to be fulfilled or these loans are expected to be restructured without any loss to the Group. The loss is then usually avoided because there is sufficient collateral.

Payments three days in arrears or less are not considered to have informational value regarding credit quality. The majority of these loans are loans to individuals where the authorised overdraft limit has expired and will be renewed again. On 31.12.2015 loans with payments three days in arrears or less amounted to ISK 39 million but on 31.12.2014 the corresponding figure was ISK 160 million.

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. Past due but not impaired assets are as follows:

| At 31 December 2015 | 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: | 10,351 | 4,975 | 1,292 | 6,954 | 23,572 |
| Individuals | 7,322 | 3,156 | 432 | 4,533 | 15,443 |
| Commerce and services | 544 | 460 | 300 | 213 | 1,517 |
| Construction | 413 | 114 | 8 | 48 | 583 |
| Energy | - | - | - | - | - |
| Financial services | - | - | - | 40 | 40 |
| Industrial and transportation | 499 | 106 | 13 | 267 | 885 |
| Investment companies | 289 | 72 | 72 | 147 | 580 |
| Public sector and non-profit organisations | 27 | 10 | - | 2 | 39 |
| Real estate | 614 | 577 | 42 | 329 | 1,562 |
| Seafood | 643 | 480 | 425 | 1,375 | 2,923 |
| Other financial assets | 765 | - | - | 22 | 787 |
| **Total** | 11,116 | 4,975 | 1,292 | 6,976 | 24,359 |

| At 31 December 2014 | Past due 4-30 days | Past due 31-60 days | Past due 61-90 days | Past due more than 90 days | Total past due loans |
|---|---|---|---|---|---|
| Loans to customers: | 12,631 | 5,379 | 1,386 | 8,223 | 27,619 |
| Individuals | 8,331 | 3,458 | 680 | 6,283 | 18,752 |
| Commerce and services | 1,144 | 516 | 256 | 337 | 2,253 |
| Construction | 429 | 116 | 76 | 293 | 914 |
| Energy | - | - | - | - | - |
| Financial services | 37 | - | - | - | 37 |
| Industrial and transportation | 390 | 156 | 104 | 231 | 881 |
| Investment companies | 145 | 363 | 47 | 211 | 766 |
| Public sector and non-profit organisations | 38 | 6 | 7 | - | 51 |
| Real estate | 914 | 602 | 179 | 274 | 1,969 |
| Seafood | 1,203 | 162 | 37 | 594 | 1,996 |
| Other financial assets | 111 | 4 | 5 | 23 | 143 |
| **Total** | 12,742 | 5,383 | 1,391 | 8,246 | 27,762 |

65. Restructuring and forbearance

When restructuring measures are believed to be more appropriate than collection procedures then the Bank can offer several debt relief measures and restructuring frameworks for its customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In many cases these measures are precursors to the more formal restructuring process.

66. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

| | 2015 | 2014 |
|---|---|---|
| Property and land | 3,504 | 5,307 |
| Industrial equipment and vehicles | 179 | 257 |

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations. The Group's employees are not permitted to purchase foreclosed assets.

67. Large exposure disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group's capital base it is considered a large exposure. Both on-balance sheet and off-balance sheet items from all types of financial instruments are included in the exposure as defined by the Financial Supervisory Authority rules 625/2013. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) of law 161/2002 on Financial Undertakings, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects eligible according to the Financial Supervisory Authority rules. After mitigating effects, the Group has currently one large exposure which is 12% of its capital base. No large exposure is above the maximum 25% single large exposure limit set by the law.

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

| | | 31.12.2015 |
|---|---|---|
| **Client groups** | Gross | Net |
| Group 1 | 117% | 0% |
| Group 2 | 12% | 12% |

| | | 31.12.2014 |
|---|---|---|
| **Client groups** | Gross | Net |
| Group 1 | 69% | 0% |
| Group 2 | 12% | 12% |

## Liquidity risk

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

### Liquidity risk management

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

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

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

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) introduced by the Basel Committee on Banking Supervision in 2010 and incorporated into European law through the CRD IV.

In preparation for the lifting of capital controls in Iceland, the implementation of the LCR and the NSFR has been ahead of that in Europe and special focus has been on setting limits regarding LCR and NSFR in foreign currencies. The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the Rules on liquidity ratio and the Rules on funding ratio in foreign currencies.

At year-end 2015, the minimum LCR requirements were 80% for the overall ratio and 100% for foreign currency denominated assets and liabilities. At the same time the minimum NSFR requirement for foreign currency denominated assets and liabilities was 80%. The table below shows the LCR and NSFR for the group at year-end 2014 and 2015. The regulatory requirements for the NSFR were not introduced until 1 December 2014.

| Liquidity coverage ratio | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Total | 143% | 130% |
| Foreign currencies | 467% | 617% |

| Net stable funding ratio | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Total | 120% | 112% |
| Foreign currencies | 141% | 126% |

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

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

### Maturity analysis 31 December 2015

| Financial liabilities | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|---|
| Short positions | 4,073 | 4,073 | - | - | - | - | - | 4,073 |
| Deposits from Central Bank and credit institutions | 25,631 | 18,905 | 6,862 | - | - | - | - | 25,767 |
| Deposits from customers | 593,245 | 358,266 | 128,895 | 37,110 | 63,649 | 20,978 | - | 608,898 |
| Debt issued and other borrowed funds | 150,308 | 2 | 5,098 | 32,107 | 105,982 | 29,524 | - | 172,713 |
| Subordinated loans | 19,517 | - | - | 736 | 23,542 | - | - | 24,278 |
| Other financial liabilities | 45,034 | 31,571 | 4,910 | 7,620 | 933 | - | - | 45,034 |
| **Total financial liabilities** | 837,808 | 412,817 | 145,765 | 77,573 | 194,106 | 50,502 | - | 880,763 |

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

68. Cont'd

| Off-balance sheet liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Financial guarantees | 11,605 | - | - | - | - | - | 11,605 |
| Undrawn loan commitments | 42,685 | - | - | - | - | - | 42,685 |
| Undrawn overdrafts | 33,131 | - | - | - | - | - | 33,131 |
| Credit card commitments | 32,115 | - | - | - | - | - | 32,115 |
| **Total** | 119,536 | - | - | - | - | - | 119,536 |
| Total non-derivative financial liabilities and off-balance sheet liabilities | 532,353 | 145,765 | 77,573 | 194,106 | 50,502 | - | 1,000,299 |

The table below shows the contractual cash flow of the Group'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 | - | 19,749 | 18,135 | 55,090 | 3,284 | - | 96,258 |
| Outflow | - | ( 19,994) | ( 18,675) | ( 55,481) | ( 3,815) | - | ( 97,965) |
| Total | - | ( 245) | ( 540) | ( 391) | ( 531) | - | ( 1,707) |
| Net settled derivatives | - | ( 601) | - | - | - | - | ( 601) |
| **Total** | - | ( 846) | ( 540) | ( 391) | ( 531) | - | ( 2,308) |

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.

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

| Financial assets | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 216,760 | 33,221 | 183,539 | - | - | - | - | 216,760 |
| Bonds and debt instruments | 78,606 | 1,551 | 24,160 | 15,708 | 33,361 | 3,826 | - | 78,606 |
| Shares and equity instruments | 18,320 | - | - | - | - | - | 18,320 | 18,320 |
| Loans to credit institutions | 35,534 | 31,064 | 4,470 | - | - | - | - | 35,534 |
| Loans to customers | 665,711 | 4,723 | 73,386 | 52,827 | 194,904 | 342,338 | - | 668,178 |
| Other financial assets | 6,675 | 2,046 | 926 | 807 | 54 | 6 | 2,835 | 6,675 |
| **Total financial assets** | 1,021,606 | 72,605 | 286,481 | 69,342 | 228,319 | 346,170 | 21,155 | 1,024,072 |

| Derivative financial assets | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 10,589 | 9,902 | 25,286 | 77 | - | 45,854 |
| Outflow | - | ( 10,488) | ( 9,289) | ( 24,257) | ( 57) | - | ( 44,091) |
| Total | - | 101 | 613 | 1,029 | 20 | - | 1,763 |
| Net settled derivatives | - | 207 | - | - | - | - | 207 |
| **Total** | - | 308 | 613 | 1,029 | 20 | - | 1,970 |

68. Cont'd

The tables below show the comparative amounts for financial assets and liabilities at the end of 2014.

**Maturity analysis 31 December 2014**

| Financial liabilities | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|---|
| Short positions | 686 | 686 | - | - | - | - | - | 686 |
| Deposits from Central Bank and credit institutions | 25,796 | 22,331 | 3,054 | 434 | - | - | - | 25,819 |
| Deposits from customers | 529,447 | 341,454 | 80,037 | 72,685 | 20,602 | 28,342 | - | 543,120 |
| Debt issued and other borrowed funds | 96,889 | 2 | 4,255 | 18,940 | 71,141 | 14,365 | - | 108,703 |
| Subordinated loans | 21,306 | - | - | 837 | 27,292 | - | - | 28,129 |
| Other financial liabilities | 45,395 | 32,715 | 5,108 | 7,868 | ( 296) | - | - | 45,395 |
| **Total financial liabilities** | 719,519 | 397,188 | 92,454 | 100,764 | 118,739 | 42,707 | - | 751,852 |

| Off-balance sheet liabilities | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| Financial guarantees | 9,124 | - | - | - | - | - | 9,124 |
| Undrawn loan commitments | 31,023 | - | - | - | - | - | 31,023 |
| Undrawn overdrafts | 28,947 | - | - | - | - | - | 28,947 |
| Credit card commitments | 29,544 | - | - | - | - | - | 29,544 |
| **Total** | 98,638 | - | - | - | - | - | 98,638 |
| Total non-derivative financial liabilities and off-balance sheet liabilities | 495,826 | 92,454 | 100,764 | 118,739 | 42,707 | 0 | 850,490 |

| 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 | - | 2,371 | 7,758 | 56,798 | - | - | 66,927 |
| Outflow | - | ( 2,292) | ( 8,165) | ( 60,437) | - | - | ( 70,894) |
| Total | - | 79 | ( 407) | ( 3,639) | - | - | ( 3,967) |
| Net settled derivatives | - | ( 133) | - | - | - | - | ( 133) |
| **Total** | - | ( 54) | ( 407) | ( 3,639) | - | - | ( 4,100) |

| Financial assets | Carrying amount | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank | 103,389 | 22,546 | 80,843 | - | - | - | - | 103,389 |
| Bonds and debt instruments | 87,347 | 1,076 | 20,645 | 25,298 | 35,209 | 5,119 | - | 87,347 |
| Shares and equity instruments | 10,531 | - | - | - | - | - | 10,531 | 10,531 |
| Loans to credit institutions | 35,072 | 23,185 | 11,837 | 50 | - | - | - | 35,072 |
| Loans to customers | 634,799 | 5,481 | 73,629 | 55,235 | 176,402 | 326,903 | - | 637,650 |
| Other financial assets | 7,619 | 1,703 | 825 | 1,865 | 54 | 27 | 3,144 | 7,619 |
| **Total financial assets** | 878,757 | 53,991 | 187,779 | 82,448 | 211,665 | 332,049 | 13,675 | 881,607 |

| Derivative financial assets | On demand | Up to 3 months | 3-12 months | 1-5 years | Over 5 years | No maturity | Total |
|---|---|---|---|---|---|---|---|
| **Gross settled derivatives** | | | | | | | |
| Inflow | - | 6,387 | 11,738 | 35,515 | 1,710 | - | 55,350 |
| Outflow | - | ( 5,885) | ( 11,063) | ( 34,724) | ( 1,975) | - | ( 53,647) |
| Total | - | 502 | 675 | 791 | ( 265) | - | 1,703 |
| Net settled derivatives | - | 242 | - | - | - | - | 242 |
| **Total** | - | 744 | 675 | 791 | ( 265) | - | 1,945 |

68. Cont'd

As a part of managing liquidity risk, the Group holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Group's liquidity back-up at the end of 2015 and end of 2014.

| **Composition and amount of liquidity back-up** | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Cash and balances with Central Bank | 216,760 | 103,455 |
| Domestic bonds eligible as collateral against borrowing at the Central Bank | 21,218 | 29,478 |
| Foreign government bonds | 41,330 | 46,593 |
| Short-term placements with credit institutions | 35,143 | 34,006 |
| **Composition and amount of liquidity back-up** | 314,451 | 213,532 |

## 69. Deposits by LCR category

The Group's deposits are categorised according to the Liquidity Coverage Ratio (LCR) introduced in the Basel III standards. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classifed as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme.

| **31 December 2015** | Deposits maturing within 30 days | | | | | |
|---|---|---|---|---|---|---|
| | Less stable | Weight (%) | Stable | Weight (%) | Term deposits | Total deposits |
| Retail | 93,385 | 10% | 56,443 | 5% | 56,122 | 205,950 |
| SME | 47,394 | 10% | 13,340 | 5% | 5,897 | 66,631 |
| Operational relationship | 2,050 | 25% | - | 5% | - | 2,050 |
| Corporations | 66,306 | 40% | 235 | 20% | 25,509 | 92,050 |
| Sovereigns, Central Bank and public sector entities | 5,723 | 40% | 257 | 20% | 970 | 6,950 |
| Financial institutions in composition | 58,428 | 100% | - | - | 39,783 | 98,211 |
| Pension funds | 23,775 | 100% | - | - | 26,765 | 50,541 |
| Domestic financial entities | 32,601 | 100% | - | - | 20,919 | 53,520 |
| Foreign financial entities | 19,033 | 100% | - | - | 1,636 | 20,669 |
| Other foreign entities | 17,936 | 100% | 1,956 | 25% | 2,413 | 22,305 |
| **Total** | 366,631 | | 72,231 | | 180,014 | 618,876 |

The table below shows the comparative amounts for financial assets and liabilities at the end of 2014.

| **31 December 2014** | Deposits maturing within 30 days | | | | | |
|---|---|---|---|---|---|---|
| | Less stable | Weight (%) | Stable | Weight (%) | Term deposits | Total deposits |
| Retail | 86,173 | 10% | 52,389 | 5% | 54,650 | 193,212 |
| SME | 44,030 | 10% | 12,654 | 5% | 6,369 | 63,053 |
| Operational relationship | - | 25% | - | 5% | - | - |
| Corporations | 77,907 | 40% | 280 | 20% | 23,636 | 101,823 |
| Sovereigns, Central Bank and public sector entities | 6,211 | 40% | 273 | 20% | 1,918 | 8,402 |
| Financial institutions in composition | 13,394 | 100% | - | - | 45,721 | 59,116 |
| Pension funds | 22,521 | 100% | - | - | 22,906 | 45,427 |
| Domestic financial entities | 22,085 | 100% | - | - | 6,083 | 28,168 |
| Foreign financial entities | 18,696 | 100% | - | - | 2,401 | 21,097 |
| Other foreign entities | 26,728 | 100% | 1,829 | 25% | 6,389 | 34,946 |
| **Total** | 317,745 | | 67,425 | | 170,073 | 555,243 |

## Market risk

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

**Market risk management**

The Group's market risk appetite is determined by the Board of Directors. The Asset and Liability Committee (ALCO) decides on limits for portfolios and products in accordance with the market risk policy approved by the Board. Risk Management is responsible for monitoring and reporting on the Group'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 Group separates exposures to market risk into trading book and banking book (non-trading portfolios). The Group'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 Group 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% (0.01 percentage point) 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, bonds issued by the Housing Financing Fund (HFF), which are guaranteed by the Icelandic government, but also domestic municipality bonds and covered bonds issued by the Icelandic banks. These positions can include short positions. Government bonds are either indexed to the Icelandic Consumer Price Index (CPI) or non-indexed, with duration up to 10 years. HFF bonds are CPI-linked and have duration up to 13 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day. In addition to BPV limits short and long positions in each instrument are subject to separate limits. Risk Management monitors these limits and reports all breaches to ALCO.

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

| **Trading bonds and debt instruments, long positions** | 31.12.2015 | | | 31.12.2014 | | |
|---|---|---|---|---|---|---|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | 1,818 | 8.08 | (1.47) | 1,772 | 8.03 | (1.42) |
| Non-indexed | 43,703 | 0.32 | (1.42) | 48,260 | 0.41 | (1.96) |
| **Total** | 45,521 | 0.63 | (2.89) | 50,032 | 0.68 | (3.38) |

| **Trading bonds and debt instruments, short positions** | 31.12.2015 | | | 31.12.2014 | | |
|---|---|---|---|---|---|---|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | 1,754 | 7.04 | 1.24 | - | - | - |
| Non-indexed | 3,057 | 1.10 | 0.34 | 73 | 7.39 | 0.05 |
| **Total** | 4,811 | 3.27 | 1.58 | 73 | 7.39 | 0.05 |

| | | | | | | |
|---|---|---|---|---|---|---|
| **Net position of trading bonds and debt instruments** | 40,710 | 0.32 | (1.31) | 49,959 | 0.67 | (3.33) |

72. Cont'd

The Bank's liquidity management assumes that part of the liquidity portfolio in foreign currencies can be invested in highly liquid bills issued by foreign governments with a long-term issuer rating of AA- from S&P or Fitch or Aa3 from Moody's. At year-end 2015 the Group held a significant amount of foreign AAA and AA+ credit-rated government bills for liquidity management purposes. These bills have a duration ranging up to six months and the sensitivity measured in BPV was ISK -0.85 million at year-end 2015 compared to ISK -1.35 million at year-end 2014.

| Foreign government bills | 31.12.2015 | | 31.12.2014 | |
|---|---|---|---|---|
| Country | Market value | BPV | Market value | BPV |
| Canada | - | - | 1,094 | ( 0.02) |
| Denmark | - | - | 1,036 | (0.02) |
| France | 6,366 | (0.14) | 6,944 | (0.30) |
| Germany | 13,439 | (0.30) | 15,434 | (0.41) |
| Netherlands | 12,025 | (0.25) | 6,944 | (0.18) |
| Norway | 1,471 | (0.07) | 1,708 | (0.04) |
| Sweden | - | - | 4,109 | (0.14) |
| USA | 8,030 | (0.09) | 9,323 | (0.24) |
| **Total** | 41,331 | (0.85) | 46,592 | (1.35) |

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

For the sensitivity analysis in the trading portfolio the Group uses as a reference the 99th percentile shift based on historical data of either five years (domestic rates) or ten years (foreign rates) and a holding period of 20 days. The following table demonstrates the sensitivity of the Group's equity and income statement to theses changes in interest rates, all other risk factors held constant. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2014 and the figures for year-end 2014 have been updated accordingly.

| Sensitivity analysis for trading bonds and debt instruments | | 31.12.2015 | | 31.12.2014 | |
|---|---|---|---|---|---|
| | | Profit or (loss) | | | |
| **Currency (ISK million)** | Parallel shift in yield curve (basis points) | Downward shift | Upward shift | Downward shift | Upward shift |
| ISK, indexed | 100 | 147 | ( 147) | 142 | ( 142) |
| ISK, non-indexed | 100 | 42 | ( 42) | 59 | ( 59) |
| EUR | 25 | 17 | ( 17) | 22 | ( 22) |
| GBP | 35 | - | - | 1 | ( 1) |
| USD | 60 | 12 | ( 12) | 15 | ( 15) |
| Other total | 60 | 4 | ( 4) | - | - |
| **Total** | | 222 | ( 222) | 239 | ( 239) |

74. Interest rate risk in the non-trading portfolio

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

The Group holds a government bond designated at fair value amounting to ISK 30.6 billion (2014: ISK 30.6 billion). The bond pays floating rates and carries relatively low interest rate risk.

The Group uses traditional measures for assessing the sensitivity of the Group'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 collective impairment allowance is subtracted and is therefore not the same as the total amount shown in the financial statement. Loans with specific impairment have been placed in the category 0-3 months since such loans bear no interest rate risk until possibly after debt restructuring. Note that collective impairment has been added to the total amount for loans to customers at 31 December 2014 as well.

Non-trading portfolio interest rate adjustment periods 31 December 2015

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|---|
| Balances with Central Bank | 216,760 | - | - | - | - | - | 216,760 |
| Bonds and debt instruments | 32,034 | 458 | 952 | 108 | 426 | 185 | 34,163 |
| Loans to credit institutions | 35,531 | 3 | - | - | - | - | 35,534 |
| Loans to customers | 463,177 | 22,748 | 38,187 | 130,927 | 2,431 | 8,241 | 665,710 |
| **Total assets** | 747,502 | 23,209 | 39,139 | 131,035 | 2,857 | 8,426 | 952,167 |
| Off-balance sheet items | 73,020 | 9,571 | 1,456 | 35,196 | - | - | 119,243 |
| **Liabilities** | | | | | | | |
| Deposits from Central Bank and credit institutions | 25,631 | - | - | - | - | - | 25,631 |
| Deposits from customers | 581,171 | 1,659 | 1,778 | 7,772 | 865 | - | 593,245 |
| Debt issued and other borrowed funds | 35,360 | 24,180 | 19,801 | 48,505 | 16,053 | 6,409 | 150,308 |
| Subordinated loans | 19,517 | - | - | - | - | - | 19,517 |
| **Total liabilities** | 661,679 | 25,839 | 21,579 | 56,277 | 16,918 | 6,409 | 788,701 |
| Off-balance sheet items | 87,095 | 6,446 | 5,968 | 28,872 | 2,976 | - | 131,357 |
| **Net interest gap on 31 December 2015** | 71,748 | 495 | 13,048 | 81,082 | ( 17,037) | 2,017 | 151,352 |

74. Cont'd

Non-trading portfolio interest rate adjustment periods 31 December 2014

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|---|---|---|---|---|---|---|---|
| Balances with Central Bank | 103,389 | - | - | - | - | - | 103,389 |
| Bonds and debt instruments | 31,119 | - | 67 | 1,230 | 291 | 367 | 33,074 |
| Loans to credit institutions | 35,072 | - | - | - | - | - | 35,072 |
| Loans to customers | 451,191 | 47,768 | 29,963 | 97,052 | 1,868 | 9,809 | 637,650 |
| **Total assets** | 620,771 | 47,768 | 30,030 | 98,282 | 2,159 | 10,176 | 809,185 |
| Off-balance sheet items | 68,186 | 7,508 | 21,649 | 112 | - | - | 97,455 |
| **Liabilities** | | | | | | | |
| Deposits from Central Bank and credit institutions | 25,375 | 421 | - | - | - | - | 25,796 |
| Deposits from customers | 514,898 | 3,643 | 1,030 | 2,383 | 7,493 | - | 529,447 |
| Debt issued and other borrowed funds | 17,723 | 9,403 | 22,760 | 34,421 | 12,582 | - | 96,889 |
| Subordinated loans | 21,306 | - | - | - | - | - | 21,306 |
| **Total liabilities** | 579,302 | 13,467 | 23,790 | 36,804 | 20,075 | - | 673,438 |
| Off-balance sheet items | 77,732 | 3,272 | 7,701 | 17,850 | - | - | 106,555 |
| **Net interest gap on 31 December 2014** | 31,923 | 38,537 | 20,188 | 43,740 | ( 17,916) | 10,176 | 126,647 |

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

For the sensitivity analysis in the banking book the Group uses as a reference the 99th percentile shift based on historical data of either 5 years (domestic rates) or 10 years (foreign rates) and a holding period of six months. The following table demonstrates the sensitivity of the Group's equity and income statement to theses changes in interest rates, all other risk factors held constant. The table shows how applied shifts would affect the fair value of the Group's banking book. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2014 and the figures for year-end 2014 have been updated accordingly.

**Sensitivity analysis for non-trading bonds and debt instruments**

| | | 31.12.2015 | | 31.12.2014 | |
|---|---|---|---|---|---|
| | | Profit or (loss) | | | |
| **Currency (ISK million)** | Parallel shift in yield curve (basis points) | Downward shift | Upward shift | Downward shift | Upward shift |
| ISK, indexed | 220 | 5,735 | ( 5,735) | 4,902 | ( 4,902) |
| ISK, non-indexed | 250 | ( 267) | 267 | ( 206) | 206 |
| CHF | 50 | ( 2) | 2 | ( 6) | 6 |
| EUR | 60 | ( 70) | 70 | ( 22) | 22 |
| GBP | 90 | 2 | ( 2) | 3 | ( 3) |
| JPY | 45 | 2 | ( 2) | 1 | ( 1) |
| USD | 150 | 11 | ( 11) | 20 | ( 20) |
| Other | 150 | ( 39) | 39 | 17 | ( 17) |
| **Total** | | 5,372 | ( 5,372) | 4,709 | ( 4,709) |

## 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 a mismatch in the currency composition of assets or liabilities.

The analysis of the Group's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements. The tables below summarise the Group's exposure to currency risk at 31 December 2015 and 31 December 2014, based on contractual currencies, off-balance sheet items, but excluding assets categorised as held for sale.

**Currency analysis 31 December 2015**

| Assets | EUR | USD | GBP | CHF | JPY | SEK | NOK | DKK | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ... | 387 | 250 | 131 | 37 | 11 | 66 | 74 | 90 | 33 | 1,079 |
| Bonds and debt instruments ................ | 31,829 | 9,867 | - | - | - | - | 1,471 | - | - | 43,167 |
| Shares and equity instruments .............. | 5,515 | 276 | 0 | - | - | - | 1 | - | - | 5,792 |
| Loans to credit institutions ..................... | 18,584 | 11,474 | 988 | 1,027 | 523 | 1,420 | 297 | 209 | 511 | 35,033 |
| Loans to customers ................................. | 62,438 | 28,980 | 5,409 | 6,907 | 6,905 | 272 | 7,340 | 1,113 | 103 | 119,467 |
| Other assets ............................................. | 432 | 1,859 | 246 | 0 | 23 | 35 | 12 | 27 | 47 | 2,681 |
| **Total assets** | 119,185 | 52,706 | 6,774 | 7,971 | 7,462 | 1,793 | 9,195 | 1,439 | 694 | 207,219 |
| | | | | | | | | | | |
| **Liabilities** | | | | | | | | | | |
| Deposits from credit institutions ........... | 1,389 | 816 | 1 | 440 | 584 | 0 | 0 | 0 | - | 3,230 |
| Deposits from customers ....................... | 66,267 | 22,351 | 5,047 | 1,488 | 1,031 | 1,103 | 2,931 | 946 | 1,356 | 102,520 |
| Debt issued and other borrowed funds . | 39,467 | - | - | - | - | 21,639 | 7,366 | - | - | 68,472 |
| Subordinated loans ................................. | 19,517 | - | - | - | - | - | - | - | - | 19,517 |
| Other liabilities ........................................ | 4,084 | 5,066 | 834 | 1 | 118 | 98 | 64 | 163 | 94 | 10,522 |
| **Total liabilities** | 130,724 | 28,233 | 5,882 | 1,929 | 1,733 | 22,840 | 10,361 | 1,109 | 1,450 | 204,261 |
| | | | | | | | | | | |
| On-balance sheet imbalance ....... | ( 11,539) | 24,473 | 892 | 6,042 | 5,729 | ( 21,047) | ( 1,166) | 330 | ( 756) | 2,958 |
| | | | | | | | | | | |
| **Off-balance sheet items** | | | | | | | | | | |
| Off-balance sheet assets .............. | 71,768 | 12,667 | 2,037 | 833 | 19 | 20,833 | 2,042 | 424 | 1,544 | 112,167 |
| Off-balance sheet liabilities ........... | 54,802 | 36,353 | 2,694 | 6,894 | 5,722 | - | 2,956 | 777 | 603 | 110,801 |
| Net off-balance sheet items | 16,966 | ( 23,686) | ( 657) | ( 6,061) | ( 5,703) | 20,833 | ( 914) | ( 353) | 941 | 1,366 |
| | | | | | | | | | | |
| Net currency imbalance on 31 December 2015 .................. | 5,427 | 787 | 235 | ( 19) | 26 | ( 214) | ( 2,080) | ( 23) | 185 | 4,324 |

# Notes to the Consolidated Financial Statements

76. Cont'd

**Currency analysis 31 December 2014**

| Assets | EUR | USD | GBP | CHF | JPY | SEK | NOK | DKK | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Cash and balances with Central Bank ... | 263 | 168 | 95 | 30 | 9 | 43 | 50 | 83 | 26 | 767 |
| Bonds and debt instruments .................. | 29,322 | 9,323 | - | - | - | 4,109 | 1,708 | 1,036 | 1,095 | 46,593 |
| Shares and equity instruments .............. | 203 | 257 | - | 1 | - | - | - | - | - | 461 |
| Loans to credit institutions ...................... | 9,092 | 12,091 | 2,137 | 3,911 | 1,238 | 1,313 | 1,442 | 2,027 | 349 | 33,600 |
| Loans to customers ................................. | 62,131 | 25,654 | 6,124 | 7,869 | 7,206 | 308 | 8,943 | 1,387 | 352 | 119,974 |
| Other assets ............................................. | 318 | 1,672 | 132 | 1 | 37 | 44 | 10 | 23 | 34 | 2,271 |
| **Total assets** | 101,329 | 49,165 | 8,488 | 11,812 | 8,490 | 5,817 | 12,153 | 4,556 | 1,856 | 203,666 |

| Liabilities | EUR | USD | GBP | CHF | JPY | SEK | NOK | DKK | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Deposits from credit institutions ........... | 140 | 16 | 13 | - | 13 | - | 1 | - | - | 183 |
| Deposits from customers ........................ | 39,200 | 26,309 | 5,385 | 2,364 | 1,586 | 1,164 | 6,777 | 1,129 | 1,892 | 85,806 |
| Debt issued and other borrowed funds . | 15,572 | - | - | - | - | 13,212 | - | - | - | 28,784 |
| Subordinated loans ................................. | 21,306 | - | - | - | - | - | - | - | - | 21,306 |
| Other liabilities ......................................... | 3,704 | 5,792 | 763 | - | 117 | 66 | 35 | 46 | 363 | 10,886 |
| **Total liabilities** | 79,922 | 32,117 | 6,161 | 2,364 | 1,716 | 14,442 | 6,813 | 1,175 | 2,255 | 146,965 |
| | | | | | | | | | | |
| On-balance sheet imbalance ....... | 21,407 | 17,048 | 2,327 | 9,448 | 6,774 | ( 8,625) | 5,340 | 3,381 | ( 399) | 56,701 |

| Off-balance sheet items | EUR | USD | GBP | CHF | JPY | SEK | NOK | DKK | Other | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| Off-balance sheet assets .............. | 19,202 | 21,345 | 662 | - | - | 9,990 | 888 | 185 | 1,614 | 53,886 |
| Off-balance sheet liabilities ........... | 29,552 | 34,234 | 79 | 8,979 | 6,468 | - | 3,634 | 140 | 920 | 84,006 |
| Net off-balance sheet items | ( 10,350) | ( 12,889) | 583 | ( 8,979) | ( 6,468) | 9,990 | ( 2,746) | 45 | 694 | ( 30,120) |
| | | | | | | | | | | |
| Net currency imbalance on 31 December 2014 .................. | 11,057 | 4,159 | 2,910 | 469 | 306 | 1,365 | 2,594 | 3,426 | 295 | 26,581 |

# Notes to the Consolidated Financial Statements

77. Sensitivity analysis for currency risk

The table below shows how the currency imbalance is affected by either depreciation or appreciation of each currency assuming other risk factors being held constant. The shift number is the 99th 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 the Group's equity and income statement would be affected by the shifts. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2014 and the figures for year-end 2014 have been updated accordingly.

**Sensitivity analysis for currency risk 31 December 2015**

| Currency (shift) | Shift effect |
|---|---|
| EUR (2%) | ( 109) |
| USD (6%) | ( 55) |
| GBP (6%) | ( 14) |
| CHF (5%) | ( 1) |
| JPY (5%) | ( 2) |
| SEK (5%) | ( 11) |
| NOK (7%) | ( 146) |
| DKK (2%) | ( 0) |
| Other (8%) | ( 19) |
| **Total** | ( 357) |

**Sensitivity analysis for currency risk 31 December 2014**

| Currency (shift) | Shift effect |
|---|---|
| EUR (3%) | ( 221) |
| USD (4%) | ( 208) |
| GBP (4%) | ( 116) |
| CHF (3%) | ( 14) |
| JPY (6%) | ( 15) |
| SEK (5%) | ( 55) |
| NOK (7%) | ( 156) |
| DKK (3%) | ( 69) |
| Other (6%) | ( 19) |
| **Total** | ( 873) |

## Shares and equity instruments

78. The Group'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 Group'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

For the sensitivity analysis the Group uses as a reference the 99th percentile shift in the domestic stock index based on historical data of five years and a holding period of 20 days for the trading book and six months for the banking book. The following table demonstrates how these shifts would affect the Group's equity and net financial income. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2014 and the figures for year-end 2014 have been updated accordingly.

| **Sensitivity analysis for equities** | | 31.12.2015 | | 31.12.2014 | |
|---|---|---|---|---|---|
| | | Profit or (loss) | | | |
| **Portfolio (ISK million)** | Change in equity prices | Downward shift | Upward shift | Downward shift | Upward shift |
| Trading | 11% | ( 368) | 368 | ( 194) | 194 |
| Non-trading | 28% | ( 2,891) | 2,891 | ( 1,602) | 1,602 |
| **Total** | | ( 3,259) | 3,259 | ( 1,796) | 1,796 |

## Derivatives

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

## Inflation risk

81. The Group is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 31 December 2015 the CPI gap amounted to ISK 42.6 billion (31 December 2014: ISK 61.7 billion). Thus, a 1% increase in the index would lead to an ISK 426 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

81. Cont'd

| Assets, CPI -linked | 31.12.2015 | 31.12.2014 |
|---|---|---|
| Bonds and debt instruments | 2,329 | 6,206 |
| Loans to customers | 223,719 | 215,320 |
| Off-balance sheet position | 31,019 | 31,046 |
| **Total assets** | 257,067 | 252,572 |
| **Liabilities, CPI-linked** | | |
| Deposits from customers | 96,424 | 97,923 |
| Debt issued and other borrowed funds | 56,909 | 50,100 |
| Off-balance sheet position | 61,112 | 42,805 |
| **Total liabilities** | 214,445 | 190,828 |
| **CPI Balance** | 42,622 | 61,744 |

## Capital management

82. Risk exposure and capital base

The table below shows the capital base, risk weighted assets ("RWA") and the resulting capital ratios of the Group at 31 December 2015 and 31 December 2014. The Group's total capital ratio, calculated according to the Act on Financial Undertakings, was 30.1% and the Tier 1 ratio was 28.3%.

The eligibility of the Tier 2 subordinated loan issued by the Group as Tier 2 capital will decrease linearly by 20% until maturity in 2019 because the remaining term is now less than 5 years. As a result the Tier 2 subordinated loan only attributes 80% into the total capital base.

The Group has revised its minimum capital targets. The previous minimum total capital target ratio of 18% has been increased to 23% for the near and medium term. The increase is based on more conservative requirements set forth by the Icelandic regulator and on the Group's view that it is prudent to retain a sizable strategic capital buffer through the near-term steps being taken towards the lifting of capital controls in Iceland. The Group expects to be able to give more clarity on the medium- to long-term capital targets in the next 12–18 months, as further clarity is expected regarding the regulatory capital requirements and the Group's operating environment.

The Group'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.

| | 2015 | 2014 |
|---|---|---|
| **Tier 1 capital** | | |
| Ordinary share capital | 10,000 | 10,000 |
| Share premium | 55,000 | 55,000 |
| Other reserves | 6,002 | 2,535 |
| Retained earnings | 127,288 | 116,288 |
| Non-controlling interests | 3,937 | 1,664 |
| Tax assets | - | ( 521) |
| Intangible assets | ( 1,331) | ( 619) |
| Other regulatory adjustments | ( 2,779) | - |
| **Total Tier 1 capital** | 198,117 | 184,347 |
| **Tier 2 capital** | | |
| Qualifying subordinated liabilities | 19,517 | 21,306 |
| Adjustment to eligible capital instruments | ( 3,903) | - |
| Other regulatory adjustments | ( 2,779) | - |
| **Total capital base** | 210,952 | 205,653 |
| **Risk weighted assets** | | |
| - due to credit risk | 606,591 | 583,375 |
| - due to market risk: | 16,607 | 33,326 |
| Market risk, trading book | 9,931 | 6,594 |
| Currency risk | 6,676 | 26,732 |
| - due to operational risk | 76,495 | 78,401 |
| **Total risk weighted assets** | 699,693 | 695,102 |
| **Capital ratios** | | |
| Tier 1 ratio | 28.3% | 26.5% |
| Total capital ratio | 30.1% | 29.6% |

# Notes to the Consolidated Financial Statements

82. Cont'd

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.

## Operational risk

83. The Group has adopted the definition of operational risk from the CRD 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, and includes legal risk“. The Group's definition of operational risk includes compliance risk, and reputational risk.

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank and its subsidiaries, in accordance with article 78 of the Financial Institution Act No. 161/2002. The policy outlines a framework for operational risk management in the Group. The operational risk management framework is described in further detail in several subdocuments, such as the Quality Management Policy, Data Policy, Business Continuity Management Framework, 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 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 Rules on the Capital Requirement and Risk Weighted Assets of Financial Undertakings No. 215/2007.

# Notes to the Consolidated Financial Statements

## Accounting policies

### 84. 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.

### 85. Changes in presentation

The following comparative amounts have been changed due to change in presentations between the years:

*a)* The Group has changed its presentation in the consolidated income statement as follows:
- The line item Share of profit or loss of associates has been included in the line item Other operating income
- The line item Administrative expenses has been split up into two lines: Salaries and related expenses and Other operating expenses

*b)* The Group has changed its presentation in the consolidated statement of financial position as follows:
- The line item Deferred tax assets has been included in the line item Other assets
- The line items Deposits from Central Bank and Deposits from credit institutions have been combined into one line: Deposits from Central Bank and credit institutions. These line items have also been combined in Notes 7, 9, 68 and 74.
- The line items Current tax liabilities and Deferred tax liabilities have been combined into one line: Tax liabilities.

*c)* Comparable information in Note 11, Net interest income, has been changed from ISK 40,521 million to ISK 40,331 million for loans and receivables and ISK (4,940) million to ISK (4,750) million for borrowings.

*d)* Comparable information in Note 36, Related party has been changed as the balances were deemed to include information which is outside the scope of the definition of a related party according to IAS24 Related party. In addition, a new line item Shareholders with control over the group was added to the disclosure and two line items were united into one in Board of Directors and key management personnel.

# Notes to the Consolidated Financial Statements

## 86. Significant accounting policies

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

Set out below is an index of the significant accounting policies, the details of which are available on the pages that follow.

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# Notes to the Consolidated Financial Statements

## 86. 1 Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries presented as those of a single economic entity. The Group consolidates its subsidiaries on the basis of control whereas subsidiaries are entities controlled by the Group.

a) *Control*

The Group controls an entity when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

The Group is exposed, or has rights, to variable returns from its involvement with an entity when the Group's returns from its involvement have the potential to vary as a result of the entity's performance.

The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the entity's returns.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

When the Group assesses whether it controls an entity, it also determines whether it is a principal or an agent. If the Group has the power to direct the activities of the entity to generate returns for itself, then it is a principal. If the Group is primarily engaged to act on behalf and for the benefit of other parties, then it is an agent and it does not control the entity when exercising its decision-making rights delegated to it. In making the assessment of whether the Group is a principal or an agent it considers the overall relationship between itself, the entity and other parties involved with the entity. In particular, the Group considers the scope of its decision-making authority over the entity, the rights held by other parties, the remuneration to which it is entitled in accordance with any remuneration agreements and the Group's exposure to variability of returns from other interests that it holds in the entity. Different weightings are applied to each of these factors on the basis of particular facts and circumstances.

The Group re-assesses whether or not it controls an entity if facts and circumstances indicate that there are changes to one or more of the elements of control.

b) *Consolidation*

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group loses control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki hf. combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities are eliminated in full on consolidation. The carrying amount of Íslandsbanki hf.'s investment in each subsidiary and Íslandsbanki's portion of equity of each subsidiary are eliminated and any related goodwill is recognised as an asset.

When the Group is committed to a sale plan involving the loss of control of a subsidiary and the criteria for classification as held for sale are met (see Note 86.13), it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements. This is regardless of whether the Group will retain a non-controlling interest in the subsidiary after the sale.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 86.29), the Group presents the gain or loss from disposal in the income statement in the line item “Profit (loss) from discontinued operations, net of income tax”.

If the Group loses control of a subsidiary, it derecognises the related assets (including goodwill), liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss. Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

c) *Non-controlling interests*

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination, the Group measures at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

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The Group presents non-controlling interests within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki hf. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki hf. and to non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

When the proportion of the equity held by non-controlling interests changes, the Group adjusts the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to equity holders of Íslandsbanki hf. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

d) *Business combinations and goodwill*

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

The acquisition cost of a business is measured as the aggregate of the consideration transferred, which is measured at acquisition date fair value, and the amount of any non-controlling interests in the acquiree, which is measured as described in Note 86.1(c). Any contingent consideration to be transferred by the Group is recognised at fair value at the acquisition date. Contingent consideration classified as an asset or liability that is a financial instrument and within the scope of IAS 39 Financial Instruments: Recognition and Measurement, is measured at fair value with the changes in fair value recognised in the consolidated income statement.

Acquisition-related costs, other than those associated with debt or equity securities issued by the Group in connection with a business combination, are expensed as incurred.

The Group recognises as of the acquisition date, separately from goodwill, the identifiable assets acquired, the liabilities assumed and any non-controlling interest in the acquiree. With certain exceptions, the identifiable assets and liabilities are recognised at their fair value at the acquisition date.

The Group recognises any goodwill arising from a business combination as an asset and measures it initially at cost, being the positive difference between (a) the aggregate of the consideration transferred, the amount of any non-controlling interest and the acquisition-date fair value of the Group's previously held equity interest in the acquiree and (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed by the Group. If this difference is negative, the Group re-assesses whether it has correctly identified all of the assets acquired and all of the liabilities assumed and reviews the procedures used to measure the amounts to be recognised at the acquisition date. If the reassessment still results in a negative difference, then the difference is recognised in profit or loss on acquisition date as a gain from a bargain purchase.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is tested by the Group for impairment annually or whenever there is an indication that it may be impaired. For the purpose of impairment testing, the Group allocates goodwill from the acquisition date to each of the Group's cash-generating units that are expected to benefit from the combination, irrespective of whether other assets or liabilities of the acquiree are assigned to those units.

Where goodwill has been allocated to a cash-generating unit and part of the operation within that unit is disposed of, the goodwill associated with the disposed operation is included in the carrying amount of the operation when determining the gain or loss on disposal. Goodwill disposed in these circumstances is measured based on the relative values of the disposed operation and the portion of the cash-generating unit retained.

## 86.2. Foreign currencies

*Foreign currency transactions*

Items included in the financial statements of each of the Group's entities are measured using the functional currency of the respective entity. Transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into functional currencies at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, adjusted for effective interest and payments during the year, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the year.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated into the functional currency at the spot exchange rate at the date that the fair value was determined.

Foreign currency differences arising on retranslation are recognised in profit or loss (see Note 86.23).

## 86.3. Financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories (see also Note 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
- Available for sale financial assets.

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 Group does not intend to sell immediately or in the near-term, other than those that the Group designates upon initial recognition as financial assets at fair value through profit or loss. Loans and receivables include loans originated by the Group to its customers and credit institutions, acquired loans, participations in loans from other lenders and finance receivables.

When the Group 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 Group.

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 86.27). Accrued interest is included in the carrying amount of the loans and receivables in the statement of financial position.

The losses arising from impairment are recognised in profit or loss in the line item “Net loan impairment”.

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

The Group 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 Group's risk management or investment strategy, and information about it is provided internally on that basis to the Group'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.

Financial assets designated by the Group 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" using the effective interest method.

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.

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d) *Financial assets available for sale*

Financial assets available for sale are non-derivative investments which the Group designates as such or are not classified as loans and receivables, financial assets held for trading or financial assets designated at fair value through profit or loss. Financial assets available for sale consist of equity instruments held by the Group for long-term investment purposes.

Financial assets available for sale are initially recognised at fair value plus transaction costs, and subsequently are carried at fair value. Changes in fair value are initially recognised directly in "Other comprehensive income, net of income taxes". The cumulative changes in fair value recognised in "Other comprehensive income" are transferred to the profit and loss in line item "Net financial income" when the financial assets are derecognised or impaired. Gains and losses on derecognition are determined using the average cost method.

Interest earned on financial assets classified as available for sale is recognised in profit or loss in the line item "Interest income" using the effective interest method. Foreign exchange gains and losses on monetary financial assets classified as available for sale are recognised in profit or loss in the line item "Net financial income". Dividends on available for sale equity instruments are recognised in profit or loss in the line item "Net financial income" when the Group's right to receive payment is established. The losses arising from impairment of financial assets classified as available for sale are recognised in profit or loss in the line item "Net loan impairment".

## 86.4. Financial liabilities

Except for financial guarantees (see Note 86.14) and loan commitments (see Note 86.15), for the purpose of measuring its financial liabilities, the Group classifies them as Financial liabilities measured at amortised cost (see also Note 7):

- Financial liabilities held for trading; or
- Financial liabilities measured at amortised cost.

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

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 recognised directly 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 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 Group 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.

## 86.5. Determination of fair value of financial assets and financial liabilities

A number of the Group's accounting policies and disclosures require the determination of fair value for measurement and/or disclosure purposes. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price).

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the balance sheet date. For all other financial instruments, the Group determines fair value using other valuation techniques.

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date. 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 Group entity and the counterparty where appropriate. Periodically, the Group calibrates the valuation techniques and tests them for validity using prices from observable current market transactions for the same instrument, without modification or repackaging, or based on other available observable market data.

# Notes to the Consolidated Financial Statements

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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 Group 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.

a) *Valuation models*

The Group measures fair values using a fair value hierarchy, which reflects the significance of the inputs used in making the measurements. Further discussion on the fair value hierarchy can be found in Note 8.

Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations.

The Group uses widely recognised valuation models for determining the fair value of common and more simple financial instruments, such as interest rate and currency swaps that use only observable market data and require little management judgement and estimation. Observable prices or model inputs are usually available in the market for listed debt and equity securities, exchange-traded derivatives and simple over-the-counter derivatives such as interest rate swaps. Availability of observable market prices and model inputs reduces the need for management judgement and estimation and also reduces the uncertainty associated with determining fair values. Availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

For more complex financial instruments, the Group 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 Group 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.

Management judgement and estimation are usually required for selection of the appropriate valuation model to be used, determination of expected future cash flows of the financial instrument being valued, determination of the probability of counterparty default and prepayments and selection of appropriate discount rates.

Fair value estimates obtained from models are adjusted for any other factors, such as liquidity risk or model uncertainties, to the extent that the Group believes that a third party market participant would take them into account in pricing a transaction. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate. For measuring derivatives that might change classification from being an asset to a liability or vice versa such as interest rate swaps, fair values take into account both credit valuation adjustment (CVA) and debit valuation adjustment (DVA) when market participants take this into consideration in pricing the derivatives.

Model inputs and values are calibrated against historical data and published forecasts and, where possible, against current or recent observed transactions in different instruments and against broker quotes. This calibration process is inherently subjective and it yields ranges of possible inputs and estimates of fair value, and management judgement is required to select the most appropriate point in the range.

b) *Valuation framework*

The Group has an established control framework with respect to the measurement of fair values. This framework includes the Group's market risk function, which is independent of front office management and reports to the Chief Risk Officer, and which has overall responsibility for independently verifying the results of trading and investment operations and all significant fair value measurements. Specific controls include, model validation and review of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Group's Investment Committee.

## 86.6. Recognition and derecognition of financial assets and financial liabilities

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

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

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The Group derecognises financial assets in the following circumstances:

- When the contractual rights to the cash flows from the financial assets expire, or
- When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:

- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

The Group enters into transactions whereby it transfers assets recognised in its statement of financial position, but retains either all or substantially all risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognised from the statement of financial position of the Group. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Group does not derecognise from its statement of financial position securities which the Group sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value. See also Note 86.27 with respect to renegotiated loans.

## 86.7. Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount presented in the consolidated statement of financial position when, and only when, the Group has a legal right to set off the amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

## 86.8. Derivative financial instruments

Derivatives entered into by the Group may be in the form of stand-alone contracts or embedded in other contracts, in which case the Group 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 Group as financial assets or financial liabilities held for trading or designated by the Group as at fair value through profit or loss.

Derivatives which do not classify as equity instruments of the Group are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities). When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

The Group did not apply hedge accounting during the year ended 31 December 2015, nor during the comparative period. Accordingly, the Group accounted for all its derivative financial assets and liabilities as financial assets or financial liabilities held for trading in accordance with Notes 86.3(c).

## 86.9. Investments in associates

Associates are entities over which the Group has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies. If the Group holds 20% or more of the voting power of an entity, it is presumed that the Group has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the Group holds less than 20% of the voting power of an entity, it is presumed that the Group does not have significant influence, unless such influence can be clearly demonstrated. The Group considers the existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, when assessing whether it has significant influence.

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. The carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets of the associate since the acquisition date. Goodwill relating to acquisitions of associates is included in the carrying amount of the investments and is not tested for impairment separately.

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases. Unrealised gains and losses resulting from transactions between the Group and the associates are eliminated to the extent of the interest in the associate.

When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and recognises the impairment loss in the consolidated income statement.

Investments in associates, or portions of them, 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 86.13. Any portions of investments in associates that have not been classified as held for sale are accounted for using the equity method until disposal of the portion that is classified as held for sale takes place. After the disposal takes place, the Group accounts for any retained interest in accordance with IAS 39 Financial Instruments: Recognition and Measurement unless the retained interest continues to be an associate, in which case the Group uses the equity method.

Upon loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

## 86.10. Leases

The Group classifies leases based on the substance of the arrangements and the extent of the transfer of risks and rewards incidental to ownership of leased assets. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

a) *Group as a lessee*

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

b) *Group as a lessor*

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

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

## 86.11. 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.

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*b) Subsequent costs*

The Group recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Group and the cost of the item can be measured reliably. 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.

## 86.12. Intangible assets

*Software*

Software acquired by the Group is measured at cost less accumulated amortisation and impairment losses.

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and impairment.

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Software is amortised on a straight-line basis in profit or loss over its estimated useful live, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is four years.

## 86.13. 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 Group expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable.

Immediately before 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 Group applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment is no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Group applicable to those liabilities.

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 IAS28 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 Group 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 86.29).

## 86.14. Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities. Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received, 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".

## 86.15. Loan commitments

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. The Group recognises a provision for loan commitments in the statement of financial position, in the line item “Other liabilities”, only when the Group 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 Group are recognised in accordance with the accounting policy disclosed in Note 86.21.

## 86.16. Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the 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 Group recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

## 86.17. Employee benefits

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

Termination benefits are recognised by the Group as a salary expense when the Group 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 Group 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 Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

## 86.18. 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.

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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.

## 86.19. 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 Group in the management of its short-term cash commitments.

## 86.20. 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 Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or 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.

## 86.21. 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 Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses, are recognised on completion of the underlying transaction.
Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria is fulfilled.

## 86.22. 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 Group 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 86.20) and foreign exchange gains and losses (which are included in the line item "Net foreign exchange gain (loss)", (see Note 86.23). Dividend income from financial assets held for trading is recognised in profit or loss when the Group'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.

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 Group 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 86.20) and foreign exchange gains and losses (which are included in the line item "Net foreign exchange gain (loss)", see Note 86.23 ). Dividend income from financial assets designated at fair value through profit or loss is recognised in profit or loss when the Group'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 Group as held for trading but which are economic hedges of financial assets designated by the Group as at fair value through profit or loss.

## 86.23. 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 Group at fair value in foreign currencies and whose other gains and losses are also recognised in profit or loss.

## 86.24. 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 information system related expenses.

## 86.25. Impairment of non-financial assets

The carrying amounts of the Group'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".

An impairment loss for non-financial assets is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised. An impairment loss in respect of goodwill is never reversed.

*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.

# Notes to the Consolidated Financial Statements

## 86.26. Bank tax

Bank tax is a tax on credit institutions which stated purpose is to create revenue for the Icelandic government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, the tax is intended as a deterrent to increased risk appetite. Following the Icelandic governments debt relief initiatives introduced in 2013, the bank tax rate was set at 0.376% of total liabilities in excess of ISK 50bn effective from 1 January 2013. The Bank tax is shown in a separate line in the income statement.

## 86.27. Net loan impairment

Net loan impairment 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.

At each reporting date, the Group assesses the current status of loans and receivables 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 loan impairment”.

a) *Impairment charges*

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.

*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 Group 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 Group'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 Group'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.

# Notes to the Consolidated Financial Statements

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*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.

If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the loans and receivables, to reflect actual and revised estimated cash flows. If there is any change in expected cash flows, the Group recalculates the carrying amount of these loans and receivables 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 Group, is recognised in profit or loss in the line item "Net loan impairment". Upwards changes in estimated future cash flows are first recognised as a reversal of previously recognised impairment losses.

*Renegotiated loans*

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and 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.

*Provision for collective impairment*

Provision for collective impairment losses reflects estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics.

## 86.28. Income tax

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations, excluding the Group's share of income tax of the Group'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 86.29).

Income tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the Group recognises it in other comprehensive income or directly in equity, consistent with the recognition of the underlying item to which it relates.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is calculated based on temporary differences between the carrying amounts of assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration any tax loss carry forwards. This difference is due to the fact that tax assessments are based on premises that differ from those governing the financial statements, mostly because revenues, especially of financial assets, are recognised earlier in the financial statements than in the tax return.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. A deferred tax asset is reduced to the extent that it is no longer probable that the related tax benefit will be realised.
Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantially enacted at the reporting date.

Tax assets are included in line items „Other assets" and deferred tax liabilities are included in line items „Tax liabilites" in the statement of financial position. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 86.13) 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.

# Notes to the Consolidated Financial Statements

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Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

### 86.29. Discontinued operations

The Group 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 Group exclusively with a view to resale that meet the criteria to be classified as held for sale (see Note 86.13) 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 Group 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 Group exclusively with a view to resale and (c) the post-tax profit or loss from the sale of foreclosed assets held for sale.

### 86.30. Offsetting income and expenses

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

### 86.31. Earnings per share

The Group presents basic and diluted earnings per share (EPS) for its ordinary shares. Basic EPS are calculated by dividing the profit or loss attributable to ordinary shareholders of the Group by the weighted average number of ordinary shares outstanding during the period. Diluted EPS are determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

### 86.32. Segment reporting

A operating segments is a component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segments is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments, and which are subject to regular review by the Group's Board of Directors and Chief Executive Officer for the purpose of allocating resources and assessing performance.

### 86.33. Initial application of new IFRS standards and amendments to standards

The new IFRS standards and amendments to standards which became effective from 1 January 2015 did not have a material impact on the Group's consolidated financial statements.

### 86.34. New IFRS standards and amendments to standards issued but not yet effective

A number of new IFRS standards and amendments to standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective.

Of all new IFRS standards and amendments to standards issued but not yet effective, the Group expects only the following ones to have an impact on its consolidated financial statements in the period of their initial application:

*a)* IFRS 9 Financial Instruments replaces the existing rules in IAS 39 Financial Instruments: Recognition and Measurement and introduces consequential amendments to other standards, such as IAS 1 Presentation of Financial Statements and IFRS 7 Financial Instruments: Disclosures. The key features of IFRS 9 are the following:

• Financial assets are required to be classified into one of three measurement categories, i.e. measured subsequently at amortised cost, measured subsequently at fair value through other comprehensive income or measured subsequently at fair value through profit or loss. The assessment as to how an asset should be classified is to be made at initial recognition. Reclassification between measurement categories is required if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the entity's operations.

• A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows.

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- A financial asset is classified as being subsequently measured at fair value through other comprehensive income if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

- All other financial assets are classified as being subsequently measured at fair value through profit or loss. In addition, there is an option at initial recognition to irrevocably designate a financial asset as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

- All investments in 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 investments in equity instruments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. For such investments 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.

- IFRS 9 retains the existing requirements in IAS 39 for embedded derivatives where the host is not a financial asset in the scope of IFRS 9, e.g. a financial liability or a lease receivable. However, derivatives embedded in financial assets that are within the scope of IFRS 9 are not to be separated. Instead, the whole hybrid financial instrument is to be assessed for classification in its entirety.

- IFRS 9 retains the existing requirements in IAS 39 for the classification of financial liabilities. For financial liabilities designated at fair value through profit or loss, the amount of change in fair value attributable to changes in the credit risk of those liabilities must, in general, be presented in other comprehensive income, with only the remaining amount of the total gain or loss being 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.

- IFRS 9 replaces the incurred loss model in IAS 39 with an expected credit loss model for calculating impairment on financial assets. The expected credit loss model in IFRS 9 will not apply to investments in equity instruments and financial assets classified as being subsequently measured at fair value through profit or loss. The expected credit loss model in IFRS 9 uses a dual measurement approach, under which the loss allowance for expected credit losses is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk of the financial instrument since initial recognition. Special rules will apply to financial assets that are credit-impaired at initial recognition.

- IFRS 9 includes a new general hedge accounting model, which aligns hedge accounting more closely with risk management. The new model does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness under IAS 39. However, under the new model more hedging strategies that are used for risk management may qualify for hedge accounting. In addition, the effectiveness test has been overhauled and replaced with the principle of economic relationship. Retrospective assessment of hedge effectiveness will also no longer be required. IFRS 9 carries forward guidance from IAS 39 on portfolio fair value hedges of interest rate risk and also allows entities to continue to apply all of the hedging requirements in IAS 39 rather than applying the new general hedge accounting model.

- IFRS 9 introduces new presentation requirements and extensive new and amended disclosure requirements, including requirements for disclosures about transition from IAS 39 to IFRS 9.

If endorsed by the EU, IFRS 9 will become mandatory for the Group starting with its consolidated financial statements for the year 2018, with retrospective application generally required but subject to specific exceptions. The Group has initiated a formal implementation project to ensure it will be ready for parallel run in 2017 and application from 1 January 2018. The Group is in the process of evaluating the possible impact of the initial application of IFRS 9 on its consolidated financial statements and as such that impact is not currently known or reasonably estimable. More disclosures are however already anticipated.

*b)* IFRS 15 Revenue from Contracts with Customers, which establishes a single comprehensive framework for reporting to users of financial statements information about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. IFRS 15 does not apply to revenue arising from financial instruments and lease contracts but it may apply to the fees charged by the Group which are not part of effective interest rate calculations. The core principle of IFRS 15 is that revenue must be recognised so as to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Revenue must be recognised in accordance with that core principle by applying a five-step model to determine when to recognise revenue and at what amount. If endorsed by the EU, IFRS 15 will become mandatory for the Group starting with its consolidated financial statements for the year 2018. The Group will have a range of options on how to account for any changes in accounting policies which might result from the initial application of IFRS 15. The Group is in the process of evaluating the possible impact of the initial application of IFRS 15 on its consolidated financial statements and as such that impact is not currently known or reasonably estimable. More disclosures are however already anticipated.

# Unaudited Appendix: Corporate Governance Statement 2015

The Board of Directors of Íslandsbanki is committed to excellence in corporate governance complying with the applicable regulatory standards and best international practices in the field of corporate governance.

Íslandsbanki's governance practises are consistent with general corporate governance guidelines for entities regulated by official supervisors and regulatory instruments. The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable law and regulations, including those imposed by the FME and Nasdaq Iceland, available at their respective websites (www.fme.is and www.nasdaqomxnordic.com). The applicable law includes, inter alia, the Act on Financial Undertakings No. 161/2002, the Act on Securities Transactions 108/2007, the Act on Competition No. 44/2005 and the Act on Public Limited Companies No. 2/1995, which along with the Íslandsbanki's Articles of Association lay the foundation for the Bank's existence and activities. The relevant law is available on the Icelandic legislature's website (www.althingi.is).

### Exemplary in Corporate Governance

Íslandsbanki is committed to maintaining high standards of governance complying with best governance practices. Íslandsbanki was first recognized as "Exemplary in Corporate Governance" in March 2014 by the Center of Corporate Governance at the University of Iceland's Institute for Business Research. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in March 2015.

Íslandsbanki maintains a Good Governance Policy, the Decision Making Matrix, which outlines all major decisions the Bank may wish to take under given circumstances. The policy is a part of the Bank's effort to improve its material actions and enhance stakeholders' trust. The Decision Making Matrix sets specific conditions to all major decision making. Furthermore, it sets the requirement that all such decisions are taken after consultation with the best qualified parties within the Bank and on the basis of the information available at the time.

### Compliance with Corporate Governance Guidelines

In accordance with Paragraph 7 of Article 54 of the Act on Financial Undertakings No. 161/2002, the Bank is required to comply with accepted guidelines on the governance of financial undertakings. The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is.

Governance practices of the Bank are consistent with the guidelines. Íslandsbanki complies with them in all respects except for certain items in 1.5, 2.9 and 5.1.2. The following discussion explains the reasons behind these exceptions as well as measures taken in relation to them;

In accordance with Article 1.5 of the guidelines the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership structure of the Bank. One candidate for board membership is nominated by the minority shareholder, ISFI, and candidates for the remaining six are nominated by the majority shareholder, ISB Holding ehf.

According to Article 2.9 of the guidelines it is preferred that the Board sets a code of ethics. The Executive Board of the Bank adopted a code of conduct for the Bank in January 2011 which all employees were involved in formulating.

Article 5.1.2 of the guidelines provides that the rules of procedure of the Board's subcommittees shall be published on the Bank's website. Each of the Board's subcommittees operates under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board which are available on the Bank's website. Moreover, a description of the role and responsibilities of the Board's subcommittees is provided on the Bank's website which the Board has considered sufficient in this respect.

### Main aspects of Risk Management and Internal Control

The Board of Directors has a supervising role monitoring the execution of set policies, the sound control of accounting and financial management and the effectiveness of group internal audit, compliance and risk management.

The management committees: The Executive Board; Risk Committee; Asset and Liability Committee; and Investment Committee, are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation. Under this authorisation, these committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite.

Group Internal Audit operates independently from other departments in accordance with Article 16 of the Act on Financial Undertakings No. 161/2002. The department provides Íslandsbanki with an independent, impartial assessment of whether the Bank's risk management, control and governance procedures are satisfactory. The Chief Audit Executive is appointed by the Board and is responsible for internal audit on a group basis.

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As a financial undertaking licensed to conduct securities transactions and an issuer of listed financial instruments, Íslandsbanki operates a compliance department. The Bank's Compliance Officer is appointed by the CEO, subject to Board confirmation, in accordance with Article 130 of the Act on Securities Transactions No. 108/2007. The Compliance officer maintains an independent position within the Bank's organisation and is responsible for monitoring and assessing regularly whether the Bank's operations, regarding securities transactions, are in compliance with applicable law. Furthermore, the Compliance Officer is the Bank's responsible officer under the US Foreign Account Tax Compliance Act (FATCA) and is also responsible for assessing and monitoring the Bank's compliance with Act on Measures against Money Laundering and Terrorist Financing No. 64/2006.

As provided for in the Bank's Articles of Association and the Act on Financial Undertakings, the Bank's audit firm shall be elected at the AGM for a term of five years. Ernst & Young ehf. was elected to serve as Íslandsbanki's independent external auditing firm at the 2015 AGM for the next five years.

Further information on the Bank's risk management structure and internal control can be found in the Bank's annual Pillar 3 Report which is published on its website.

In 2015 the Consumer Appeals Committee upheld two rulings of the Icelandic Consumer Agency from 2014 where it found Íslandsbanki to be in violation of certain provisions of the expired Act on Consumer Credit no. 121/1994 and the Act on Supervision of Commercial Practices and Transparency of the Market No. 57/2005. The Bank did not agree with the committee's rulings. In relation to one of those rulings, regarding indexed loans, the Icelandic Supreme Court has, in a comparable matter of dispute, ruled that Íslandsbanki was not in violation of the Consumer Credit Act from 1994, therefore the ruling of the Appeals Committee is of no consequence. The dispute of the other case, regarding the method and conditions of resetting interest of consumer mortgages, has been referred to the district court. Moreover, the Data Protection Authority found Íslandsbanki's Ergo - Assed-based Financing to be in violation of Act. No. 77/2002, on the Protection of Privacy as regards the Processing of Personal Data, in relation to a single particular lookup in a debt write-off register. Further information on this, and other legal cases relating to Íslandsbanki, can be found in the notes to the consolidated financial statements.

### Íslandsbanki Values, Code of Conduct and Social Responsibility

Íslandsbanki's values are the pillars of the Bank's corporate culture, shaping the conduct and attitudes of its employees. The values insist on employees being professional, disciplined in their working procedures, and following matters through – professional, positive and progressive.

In order to maintain and strengthen the credibility and the reputation of the Bank, all employees were involved in formulating the Bank's Code of Conduct which is available on the Bank's website. The aim of the code is to promote good operational and business practices, increase trust and guide employees in their daily work.

Íslandsbanki seeks to work in harmony with the communities in which it operates, delivering support for its immediate environment in the areas of culture, sports, community affairs as well as entrepreneurship and innovation. This participation in community programmes rests on Íslandsbanki's Corporate Social Responsibility Strategy which is set by the Board. The strategy covers five key areas: business, education, environment, human capital, and society. Furthermore, the Bank produces an annual report, Íslandsbanki in the Community: Global Compact, which can be accessed on the Bank's website. For the last eight years Íslandsbanki has been a signatory to the UN Global Compact on social responsibility. The compact is a guide for companies on how to be socially responsible in practice.

### Board of Directors

The Board of Directors comprises seven non-executive directors, and two alternates, elected at each AGM for a term of one year. The Chairman of the Board is elected by the shareholders' meeting. There are no limitations on duration of Board membership.

The Board undertakes the Bank's affairs in between shareholders' meetings unless otherwise provided by law or the Bank's Articles of Association. The Board is responsible for setting the Bank's general strategy and instructs the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations and good business practices. The Board appoints the CEO and Chief Audit Executive.

The Rules of Procedure of the Board are adopted in accordance with Article 70 of the Act on Public Limited Companies No 2/1995 and Article 54 of the Act on Financial Undertakings No 161/2002. The Board's current rules of Procedure, adopted on 11 November 2015, are available on the Bank's website. According to its Rules of Procedure, at meetings of the Board the presence of at least five members of the Board is required to constitute a quorum. The Board met 17 times in 2015, each time constituting a quorum.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board:

The Board Audit Committee, comprising three Board members, assists the Board in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control, the audit process and the Bank's process for monitoring compliance with the relevant laws and regulations and its code of ethics. The committee met 7 times in 2015, each time constituting a quorum.

The Board Risk Management Committee, which comprises three Board members, is responsible for assisting the Board in providing oversight of senior management's activities in managing risk relevant to the Bank's operations. This includes credit risk, market risk, operational risk, liquidity risk, compliance risk and reputational risk. The committee met 5 times in 2015, each time constituting a quorum.

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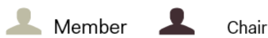
The Board Strategy Committee, which comprises of four Board members, oversees and approves key issues related to the strategy of the Bank and formulates general policies to effectively implement that strategy. The committee sets out strategic and financial targets and monitors their progress. The committee met 5 times in 2015, each time constituting a quorum.

The Board Corporate Governance, Compensation and Human Resource Committee, which comprises four Board members, assists the Board in overseeing the development and the regular assessment of the Bank's approach to corporate governance issues and board effectiveness. Furthermore it is responsible for providing oversight regarding compensation and human resource issues. The committee met 6 times in 2015, each time constituting a quorum.

Structure and composition of Board subcommittees is as follows:

| | The Board Audit Committee | The Board Risk Management Committee | The Board Strat-egy Committee | The Board Corporate Governance, Compensation and HR Committee |
|---|---|---|---|---|
| Fridrik Sophusson | | | Member | Chair |
| Marianne Økland | Member | Chair | | |
| Árni Tómasson | Member | Member | | |
| Eva Cederbalk | | | Chair | Member |
| Gunnar Fjalar Helgason | | | Member | Member |
| Helga Valfells | | Member | | Member |
| Neil Graeme Brown | Chair | | Member | |




**Members of the Board**

Fridrik Sophusson, chairman of the Board, born in 1943 and is an Icelandic national. He holds a Cand. Jur. degree in Law from the University of Iceland. He joined the Board in January 2010. He also serves as chairman of the board of Hlídarendi ses. and Úlfljótsvatn sf. as well as as an alternate board member of Fondament ehf.

Marianne Økland, vice-chairman of the Board, born in 1962 and is a Norwegian national. She has an M.Sc. degree in finance and economics from the Norwegian School of Economics and Business Administration. She joined the Board in January 2010 and has been vice-chairman since March 2015. She is the managing director of Avista Partners. She also serves as board member of IDFC and Scorpio Tankers Inc.

Árni Tómasson, born in 1955 and is an Icelandic national. He has a Cand. Oecon degree in business from the University of Iceland and is a state authorized public accountant. He joined the Board in January 2010. He runs his own consulting firm, AT rádgjöf ehf. and serves as a board member of Reviva Capital S.A., AT Rádgjöf ehf., Skjaldborg Kröfuhafafélag 10 ehf. and Kaffitár hf.

Eva Cederbalk, born in 1952 and is a Swedish national. She has an M.Sc. degree in International Economics and Marketing from Stockholm School of Economics. She joined the Board in March 2015. She works as an independent consultant and is the owner, chairman of the Board and CEO of Cederbalk Consulting. She serves as chairman of the board of Klarna Holding AB/Klarna AB, Diakrit International Ltd. and TicWorks AB and is a Board member of Ikano S.A., Stockhomls Almänna Brandkontor, KK-Stiftelsen and Investment AB Svolder.

Gunnar Fjalar Helgason, born in 1971 and is an Icelandic national. He has a B.Sc. degree in Economics from the University of Iceland. He joined the Board in September 2015 but has served as alternate member since September 2013. He is the Head of Corporate Strategy for the Síminn group as well as owner and chairman of the Board of Frost Capital ehf. He serves as chairman of the Board of Farsímagreidslur ehf., On-Waves ehf., Radíómidun ehf., Sensa ehf., Staki automation ehf. and Talenta ehf. He is also a board member of GO loyality solutions ehf., GSOB ehf., Hringtorg ehf., HT Mobile ehf., Trackwell hf. and Truenorth ehf.

Helga Valfells, born in 1964 and is an Icelandic national. She holds an MBA degree from London Business School, UK, and a B.A. degree in Economics and English Literature from Harvard University. She joined the Board in September 2013. She is CEO of NSA Ventures, co-owner and managing director of Árhólmi ehf., co-owner and alternate board member of Uggi ehf. She serves as chairman of the board of Frumtak GP ehf. and is a member of the boards of Althjódaskólinn á Íslandi ehf., AMP ehf., Klak Innovit ehf., Mentor ehf., Transmit ehf., and Vesturgardur ehf. An alternate board member of Akthelia ehf., Azazo hf., FSÍ (Framtakssjódur Ísl)GP hf., Gangverd ehf., Greenqloud ehf., InfoMentor ehf. and Norrænar Myndir ehf.

Neil Graeme Brown, born in 1959 and is a British national. He has an M.A. degree in classics from Emmanuel College, Cambridge and is an associate of the Institute of Chartered Accountants (ACA). He joined the Board in January 2010. He is a founding partner of Subito Partners, a London based board advisory and investment business. He is also co-owner of Lanista Partners Ltd., Distribution Technology Ltd., The Oxford Artesan Distillery and Vox Pop Me as well as co-owner and board member of Verve Partners Ltd. He is board member of Magma Fincorp and NG Energy Ltd.

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Alternate members of the Board are two; Margrét Kristmannsdóttir, since September 2014 and Jón Eiríksson since January 2011.

All members of the Board are considered independent from the Bank and large shareholders of the Bank except for Árni Tómasson who is not considered independent on account of his work for Glitnir hf. during the course of the past three years.

Board Performance Assessment

At least once a year, as provided for in the Board's Rules of Procedure, the Board assesses its work, procedures and practices. This performance assessment is intended to improve working methods and increase the efficiency of the Board. The assessment entails an evaluation of the strengths and weaknesses of the Board's work and practices. This is i.a. based on Board members' self-assessment on whether the Board rules of procedure have been complied with in all respects, a status taken of the specific priorities set by the Board regarding risk management and internal control within the Bank as well as a follow up on how certain decisions of the Board have been implemented.

**Executive Management**

The Chief Executive Officer (CEO) is responsible for the day-to-day operations of the Bank pursuant to set policies and resolutions of the Board. The CEO is also to ensure that the Bank's operations are in compliance with applicable law and the Articles of Association at all times. The CEO appoints the Bank's Compliance Officer, members of the Executive Board and members of other management committees.

Birna Einarsdóttir is the CEO of Íslandsbanki, born in 1961 and is an Icelandic National. She has a Cand. Oecon. degree in Business Administration from the University of Iceland and an MBA degree from the University of Edinburgh. Birna has been with Íslandsbanki and its predecessors in various divisions for a total of 20 years. Previously she was a senior product manager at Royal Bank of Scotland and has worked as marketing manager for Íslenska útvarpsfélagid and Íslensk Getspá.

Together with the CEO, the Executive Board manages the daily activities of the Bank according to the strategy set out by the Board. It consists of 9 people, including the CEO: Birna Einarsdóttir, CEO since October 2008, Björgvin Ingi Ólafsson, Managing Director of Relationship Banking since September 2014, Elín Jónsdóttir, Managing Director of Asset Management since July 2014, Jón Gudni Ómarsson, Chief Financial Officer since October 2011, Sigrídur Olgeirsdóttir, Chief Operating Officer since September 2010, Sverrir Örn Thorvaldsson, Chief Risk Officer since November 2010, Tryggvi Björn Davídsson, Managing Director of Markets since September 2011, Una Steinsdóttir, Managing Director of Retail Banking since October 2008 and Vilhelm Már Thorsteinsson Managing Director of Corporate Banking since October 2008.

The CEO and management committees are responsible for implementing risk management practices and internal monitoring in accordance with Board authorization. The committees are appointed by the CEO, and their letters of mandate and rules of procedure approved by the Board:

The Executive Board is responsible for the Bank's operational risk management framework and supervises legal risk, reputational risk, business risk and strategic risk as well as the Bank's formal product approval policy.

The Risk Committee manages and supervises lending issues and other counterparty risk, in accordance with the Bank's credit policy and lending rules.

The Asset and Liability Committee monitors other financial risks, such as market risk, liquidity risk, and interest rate risk in the Bank's non-trading portfolio.

The Investment Committee makes decisions on the purchase or sale of equity holdings in companies, as well as other types of investments, including investment funds and real estate.

Further to the above three other departments report directly to the CEO; Legal department, Human Resources, and Compliance.

**Arrangement of communications between shareholders and the Board**

The Board communicates with shareholders in accordance with the relevant laws, the Bank's Articles of Association and the Board's Rules of Procedure. Members of the Board of Directors shall, in their duties and decision-making, safeguard the interests of the Bank and shareholders in accordance with the provisions of Act No. 2/1995, on Public Limited Companies, Act No. 161/2002, on Financial Undertakings, and other relevant rules and guidelines about the activities of financial undertakings.

At the end of 2015 Glitnir Bank hf. held 95% of the share capital in Íslandsbanki through its subsidiary ISB Holding ehf. The remaining 5% was held by the Icelandic government and administered by the Icelandic State Financial Investments (ISFI). In January 2016 Glitnir hf., as part of the creditor's group stability contribution, relinquished all of its shares to the Icelandic government. Shareholders' meetings are the general forum for informing and communicating with shareholders. In between meetings of the Bank's shareholders the Chairman of the Board, on behalf of the Board of directors, is responsible for communications with shareholders.

Shareholders can at any time express their views in relation to the operations of the Bank to the Board of Directors and submit queries to the Board for discussion.

*This Corporate Governance Statement was approved by Íslandsbanki's Board of Directors on 20 January 2016.*