Arion Bank

Condensed Consolidated
Interim Financial Statements

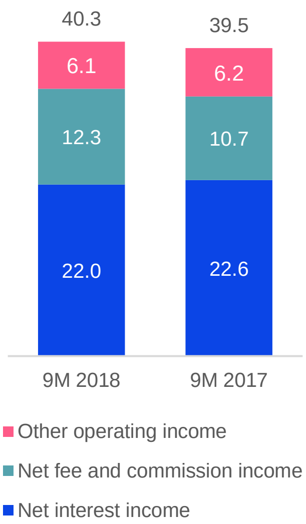
1 January - 30 September 2018

Contents

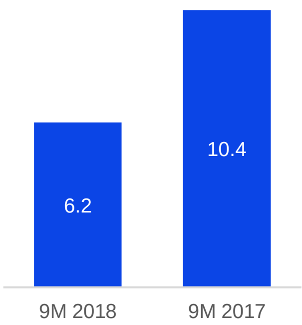
Key figures

9M January to September

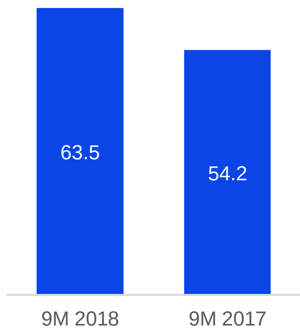
Operating income
(ISK billion)



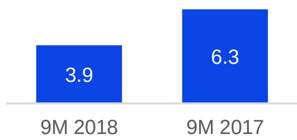
Net earnings
(ISK billion)



Cost to income
(%)

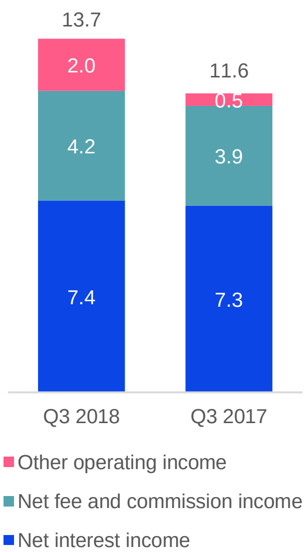


Return on equity
(%)

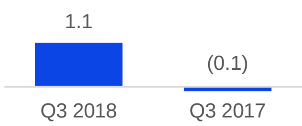


Q3 July to September

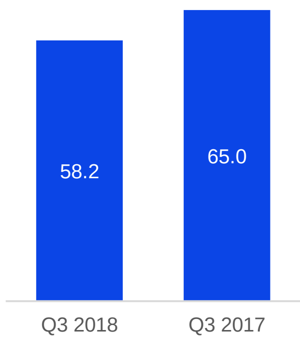
Operating income
(ISK billion)



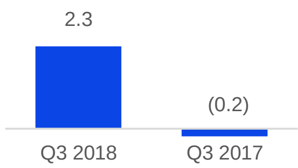
Net earnings
(ISK billion)



Cost to income
(%)

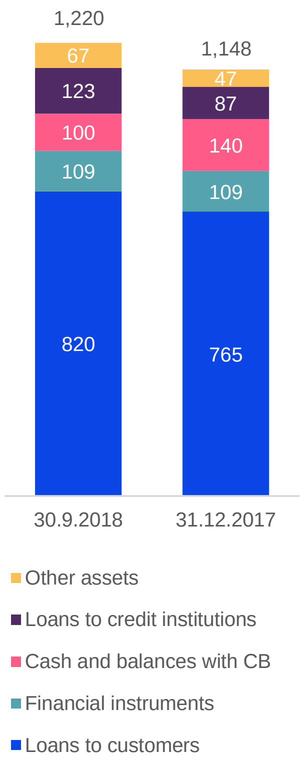


Return on equity
(%)

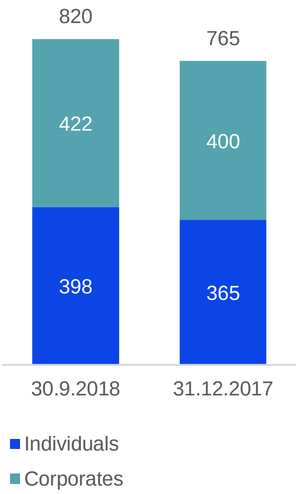


Key figures

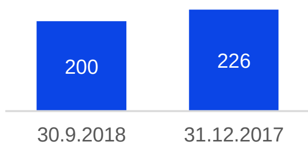
Total assets
(ISK billion)



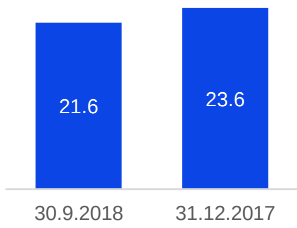
Loans to customers
(ISK billion)



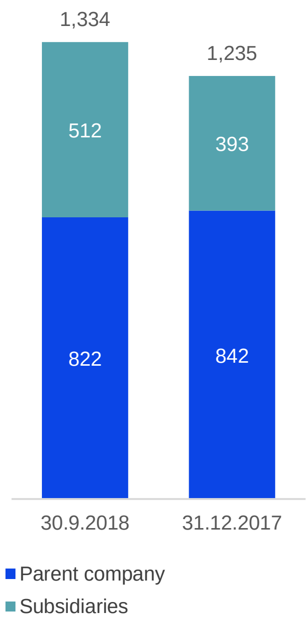
Total equity
(ISK billion)



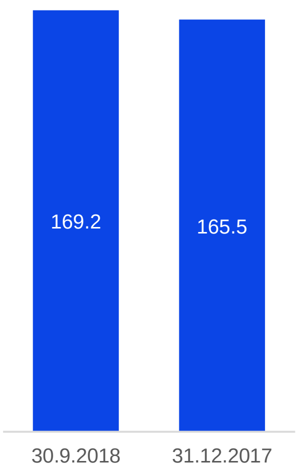
CET 1
(%)



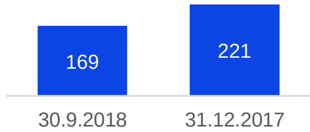
Number of FTE's



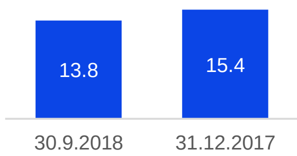
Loans to deposit ratio
(%)



LCR
(%)



Leverage ratio
(%)



Endorsement and statement
by the Board of Directors and the CEO

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period from 1 January to 30 September 2018 include the Condensed Consolidated Interim Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

Outlook

The economy has performed well so far in 2018 as is evident by GDP growth which measured 6.4% in the first half of the year. The composition of different growth factors has been exceptionally favorable, with foreign trade making a positive contribution to growth and investment standing its ground. Private consumption is, however, still the main driving force, but growth is rapidly slowing down. Despite a strong first half of the year, analysts still expect slower growth as the year progresses. Although tourism remains high volume, it has passed its peak growth, payment card turnover indicates slower private consumption growth, and business investment has taken a backseat when it comes to investment growth, passing the baton on to housing investment. Inflation is still low in a historical context but is currently above the Central Bank of Iceland's inflation target. It is likely that inflationary pressures will continue to pick up, with a weaker króna and challenging general wage negotiations on the horizon. Arion Bank Research predicts that there is moderate GDP growth ahead coupled with a narrowing of the output gap, relatively low unemployment and a possible rise in inflation in the coming months.

Operations during the period

Net earnings in the third quarter of 2018 amounted to ISK 1,149 million and total equity amounted to ISK 200,056 million at the end of the quarter. Return on equity was 2.3% in the quarter. Net earnings amounted to ISK 6,160 million in the first nine months of 2018 and return on equity was 3.9% for the period. The capital ratio of the Bank, according to the Financial Undertakings Act No. 161/2002, was 21.7% and the corresponding CET 1 ratio was 21.6%. According to the Financial Undertakings Act No. 161/2002 the official capital ratio shall be based on the audited or reviewed own funds. Since the Interim Financial Statements for the third quarter are not audited the official capital ratio is based on the reviewed own funds on 30 June 2018 and risk-weighted assets on 30 September 2018. The official capital ratio on 30 September was 21.7% and the Official CET 1 ratio was 21.6%, which comfortably meets the requirements set by law and the Financial Supervisory Authority (FME).

The main changes in the Statement of Financial Position from the end of June relate to a dividend payment in September amounting to ISK 9.1 billion, an increase in loans to customers of ISK 16.3 billion, or 2.0%, an increase in deposits of ISK 8.4 billion, or 1.8%, and an increase in borrowings of ISK 14.8 billion, or 3.6%. New lending during the third quarter is mainly in the form of mortgages to individuals.

The Bank's liquidity position is strong, with a liquidity coverage ratio of 169%, see Note 42, well above the regulatory minimum of 100%. Wholesale funding activities in the third quarter were minimal; an issuance of covered bonds amounting to ISK 10.3 billion and bills amounting to ISK 4.9 billion.

The Bank continues its digital journey and will launch five digital solutions in Q4, bringing the total to nine solutions during the year. The Bank's objective is to enhance customer experience and improve cost efficiency through its digital solutions.

In June 2018 Arion Bank appointed an international management consultancy company to carry out a strategic review of the future ownership of the subsidiary Valitor. This review has now been completed and the Bank is now in the process of selecting an international investment bank to manage the sale of part or all shares in Valitor.

In October 2018 Primera Air, a client of the Bank, filed for bankruptcy. Arion Bank had to make impairment and pay out guarantees which negatively affected the financial results of the Bank by ISK 1.8 billion in the third quarter of 2018.

During the period Arion Bank has continued working on matters concerning the subsidiary Stakksberg ehf., an entity that holds the former assets of United Silicon. The Bank aims to conduct a sales process of Stakksberg ehf. as soon as possible.

Arion Bank was acknowledged for its efforts towards advancing gender equality when it became the first Icelandic bank to be allowed to use the Equal Pay Symbol. Furthermore, the Bank was in 17th place out of 329 listed companies in Sweden in terms of gender equality in management teams according to the AllBright foundation in Sweden.

Endorsement and statement
by the Board of Directors and the CEO

Capital

In October of this year, the FME's annual Supervisory Review and Evaluation Process (SREP) for Arion Bank was concluded. The additional capital requirement under Pillar 2 is determined on the basis of the Group's internal capital adequacy assessment. The additional requirement is 2.9% of risk-weighted assets (RWA) based on the Group's Financial Statements as at 31 December 2017, excluding insurance subsidiaries. The previous requirement was 3.4% of RWA and the reduction is primarily due to reduced assessment of credit risk and legal risk. As a result, the Bank's total regulatory requirement, including capital buffer requirements, is reduced from 19.8% to 19.3%. The increase in the countercyclical capital buffer rate by 0.5%, which comes into effect in May 2019, will however increase the total capital requirement back to 19.8%, if all other factors remain unchanged. Taking into account the Group's internal management buffer, currently 1.5% of RWA, the Group's capital requirement is 21.3%. The Group's target CET1 ratio is 17%.

The Group's capital ratio at 30 September 2018 was 21.7%. For the past few years, the Group has operated with own funds well in excess of the minimum requirements, and the requirements have been met primarily by Common Equity Tier 1 (CET1) capital. The Bank has recently taken active steps to reduce capital, which is the first step in the effort to normalize the Bank's capital structure in accordance with its capital policy. The timing of the issuance of capital instruments will depend on, among other things, market pricing and the Bank's liquidity in Icelandic króna. With the Bank now operating on a capital level close to the requirements, the Bank will increase its focus on capital management with the aim to improve returns.

Employees

The Group had 1,334 full-time equivalent positions at the end of September, compared with 1,309 at the end of June and 1,284 at the end of 2017; 822 of these positions were at Arion Bank, compared with 823 at the end of June and 844 at the end of 2017. The increase in FTEs from year-end is mainly due to the growth strategy of Valitor on international markets but is partly off-set by a decrease at the Bank due to the outsourcing of its cash center.

Group ownership

Following the IPO in June this year the Bank has seen the shareholder base continue to grow, although there have been no major changes to the largest shareholdings. A new name on the shareholder list (>1%) is the Icelandic pension fund Gildi which has acquired 1.27% in the Bank according to the registers on 30 September 2018. The current shareholder register is made up of a shareholder register in Iceland and an SDR register in Sweden, see Note 34.

The total voting rights of Kaupthing ehf., through Kaupskil ehf., and Taconic Capital Advisors LP and related parties, through TCA New Sidecar S.á.r.l., are restricted to 33% of total voting rights in the Bank according to FME notification from 22 September 2017.

Governance

At the last annual general meeting, seven members were elected to serve on the Board of Directors until the next annual general meeting, three women and four men. As one board member resigned in September an Alternate Director will attend meetings until a new board member has been elected. Furthermore, three Alternate Directors (two men and one woman) are elected and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. The ratio of men to women is therefore in compliance with the law which states that companies with more than 50 employees should ensure that the ratio of either gender on the board of directors should not be less than 40%. Five Directors and two Alternates are independent of Arion Bank and its day-to-day managers as well as of Arion Bank's significant shareholders.

At Arion Bank's extraordinary shareholders' meeting on 5 September 2018, Benedikt Gíslason was elected as a new Director and replaced Jakob Ásmundsson, who stepped down from the Board of Directors of Arion Bank on 30 May 2018. On 5 September 2018 John P. Madden, a Director, decided to step down from the Board of Directors of Arion Bank.

Endorsement and statement
by the Board of Directors and the CEO

Endorsement of the Board of Directors and the Chief Executive Officer

The Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 September 2018 have been prepared in accordance with International Financial Reporting Standards as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and Rules on Accounting for Credit Institutions.

It is our opinion that the Condensed Consolidated Interim Financial Statements give a true and fair view of the financial performance of the Group for the period ended 30 September 2018 and its financial position as at 30 September 2018.

Furthermore, in our opinion the Condensed Consolidated Interim Financial Statements and the Endorsement of the Board of Directors and the CEO give a fair view of the development and performance of the Group's operations and its position and describe the principal risks and uncertainties faced by the Group.

The Board of Directors and the CEO have today discussed the Condensed Consolidated Interim Financial Statements of Arion Bank for the period ended 30 September 2018 and confirm them by means of their signatures.

Reykjavík, 31 October 2018

Board of Directors

Eva Cederbalk
Chairman

Brynjólfur Bjarnason

Benedikt Gíslason

Herdís Dröfn Fjeldsted

Måns Höglund

Ólafur Örn Svansson

Steinunn K. Thórdardóttir

Chief Executive Officer

Höskuldur H. Ólafsson

Consolidated Interim Income Statement
for the period from 1 January to 30 September 2018

Income Statement

	Notes	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Interest income		43,652	43,288	15,182	13,448
Interest expense		(21,686)	(20,718)	(7,737)	(6,198)
Net interest income	**6**	**21,966**	**22,570**	**7,445**	**7,250**
Fee and commission income		24,789	20,881	6,883	7,862
Fee and commission expense		(12,509)	(10,178)	(2,637)	(3,997)
Net fee and commission income	**7**	**12,280**	**10,703**	**4,246**	**3,865**
Net financial income	8	2,849	2,471	582	(734)
Net insurance income	9	1,885	1,769	984	716
Share of profit of associates and net impairment	25	18	(917)	34	17
Other operating income	10	1,310	2,858	431	483
Other net operating income		**6,062**	**6,181**	**2,031**	**482**
Operating income		**40,308**	**39,454**	**13,722**	**11,597**
Salaries and related expenses	11	(13,815)	(12,624)	(4,168)	(3,841)
Other operating expenses	12	(11,777)	(8,756)	(3,817)	(3,699)
Operating expenses		**(25,592)**	**(21,380)**	**(7,985)**	**(7,540)**
Bank levy	13	(2,621)	(2,388)	(937)	(814)
Net impairment	14	(2,969)	(1,262)	(2,678)	(2,551)
Earnings before tax		**9,126**	**14,424**	**2,122**	**692**
Income tax expense	15	(3,078)	(4,071)	(973)	(805)
Net earnings from continuing operations		**6,048**	**10,353**	**1,149**	**(113)**
Discontinued operations, net of tax	16	112	-	-	-
Net earnings		**6,160**	**10,353**	**1,149**	**(113)**

Attributable to

	Notes	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Shareholders of Arion Bank hf.		5,549	10,351	1,151	(113)
Non-controlling interest		611	2	(2)	-
Net earnings		**6,160**	**10,353**	**1,149**	**(113)**

Earnings per share from continuing operations

	Notes	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	17	2.94	5.18	0.63	(0.06)

Comparative figures have been changed, see Note 1.

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of other Comprehensive Income
for the period from 1 January to 30 September 2018

Other Comprehensive Income	Notes	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Net earnings		**6,160**	**10,353**	**1,149**	**(113)**
Net gain on financial assets carried at fair value through OCI, net of tax		152	-	149	-
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement*		(110)	-	2	-
Changes to reserve for financial instruments at fair value through OCI	33	**6,202**	**10,353**	**1,300**	**(113)**
Exchange difference on translating foreign subsidiaries	33	209	(27)	197	56
Total comprehensive income		**6,411**	**10,326**	**1,497**	**(57)**

Attributable to

Shareholders of Arion Bank	5,800	10,324	1,499	(57)
Non-controlling interest	611	2	(2)	-
Total comprehensive income	**6,411**	**10,326**	**1,497**	**(57)**

Comparative figures have been changed, see Note 1.

*Fair value gain of ISK 205 million would have been recognized in the Income Statement during the period if the financial assets had not been reclassified as Financial assets carried at FVOCI, net of tax, in accordance with IFRS 9.

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Financial Position
as at 30 September 2018

Assets	Notes	30.9.2018	31.12.2017
Cash and balances with Central Bank	18	99,525	139,819
Loans to credit institutions	19	123,446	86,609
Loans to customers	20	819,965	765,101
Financial instruments	21-23	109,374	109,450
Investment property	23	7,044	6,613
Investments in associates	25	862	760
Intangible assets	26	14,039	13,848
Tax assets	27	623	450
Non-current assets and disposal groups held for sale	28	8,351	8,138
Other assets	29	36,300	16,966
Total Assets		**1,219,529**	**1,147,754**
Liabilities			
Due to credit institutions and Central Bank	22	15,370	7,370
Deposits	22	484,569	462,161
Financial liabilities at fair value	22	3,381	3,601
Tax liabilities	27	6,376	6,828
Other liabilities	30	84,176	57,062
Borrowings	22,31	425,601	384,998
Total Liabilities		**1,019,473**	**922,020**
Equity			
Share capital and share premium	33	59,014	75,861
Other reserves	33	15,648	16,774
Retained earnings		124,655	132,971
Total Shareholders' Equity		**199,317**	**225,606**
Non-controlling interest		739	128
Total Equity		**200,056**	**225,734**
Total Liabilities and Equity		**1,219,529**	**1,147,754**

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Changes in Equity
for the period from 1 January to 30 September 2018

	Share capital and share premium	Other reserves	Retained earnings	**Total share-holders' equity**	Non-controlling interest	**Total equity**
Equity 31 December 2017	75,861	16,774	132,971	225,606	128	225,734
Impact of adopting IFRS 9	-	3	939	942	-	942
Restated opening balance under IFRS 9	**75,861**	**16,777**	**133,910**	**226,548**	**128**	**226,676**
Net earnings	-	-	5,549	5,549	611	6,160
Net gain on financial assets carried at fair value through OCI, net of tax	-	152	-	152	-	152
Realized net gain on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	-	(110)	-	(110)	-	(110)
Translation difference	-	209	-	209	-	209
Total comprehensive income	**-**	**251**	**5,549**	**5,800**	**611**	**6,411**
Dividend paid	-	-	(16,184)	(16,184)	-	(16,184)
Purchase of treasury stock	(17,139)	-	-	(17,139)	-	(17,139)
Own shares allocated to employees	292	-	-	292	-	292
Reserve for investments in subsidiaries	-	(1,168)	1,168	-	-	-
Reserve for investments in associates	-	17	(17)	-	-	-
Reserve for investments in securities	-	(337)	229	(108)	-	(108)
Reserve for financial instruments at FVOCI	-	108	-	108	-	108
Equity 30 September 2018	**59,014**	**15,648**	**124,655**	**199,317**	**739**	**200,056**
Equity 1 January 2017	75,861	19,761	115,590	211,212	172	211,384
Net earnings	-	-	10,351	10,351	2	10,353
Translation difference	-	(27)	-	(27)	-	(27)
Total comprehensive income	**-**	**(27)**	**10,351**	**10,324**	**2**	**10,326**
Reserve for investments in subsidiaries	-	(4,839)	4,839	-	-	-
Reserve for investments in associates	-	26	(26)	-	-	-
Reserve for investments in securities	-	81	(81)	-	-	-
Equity 30 September 2017	**75,861**	**15,001**	**130,673**	**221,535**	**174**	**221,709**

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 September 2018

	2018	2017
Operating activities	1.1.-30.9.	1.1.-30.9.
Net earnings	6,160	10,353
Non-cash items included in net earnings and other adjustments	(10,238)	(17,205)
Changes in operating assets and liabilities	(19,254)	47,222
Interest received	41,024	34,679
Interest paid	(13,866)	(7,586)
Dividend received	3,075	197
Income tax paid	(3,939)	(2,059)
Net cash from operating activities	**2,962**	**65,601**
Investing activities		
Acquisition of associates	(60)	(961)
Acquisition of subsidiary	-	(1,446)
Dividend received from associates	-	41
Acquisition of intangible assets	(1,456)	(1,477)
Acquisition of property and equipment	(502)	(573)
Proceeds from sale of property and equipment	8	231
Net cash to investing activities	**(2,010)**	**(4,185)**
Financing activities		
Dividend paid to shareholders of Arion Bank	(16,184)	-
Purchase of treasury stock	(17,139)	-
Net cash used in financing activities	**(33,323)**	**-**
Net (decrease) increase in cash and cash equivalents	(32,371)	61,416
Cash and cash equivalents at beginning of the year	181,898	123,933
Cash and cash equivalents acquired through business combinations	-	128
Effect of exchange rate changes on cash and cash equivalents	2,401	992
Cash and cash equivalents	**151,928**	**186,469**
Non-cash investing transactions		
Assets acquired through foreclosure on collateral from customers with view to resale	518	542
Settlement of loans through foreclosure on collateral from customers with view to resale	(518)	(542)
Non-cash changes due to acquisition of United Silicon		
Deposits	4,537	-
Borrowings	(4,537)	-

Comparative figures have been changed with immaterial effects on the Cash flow, see Note 1.

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Notes to the Consolidated Interim Statement of Cash flows
for the period from 1 January to 30 September 2018

Non-cash items included in net earnings	2018 1.1.-30.9.	2017 1.1.-30.9.
Net interest income	(21,966)	(22,570)
Net impairment	2,974	1,262
Income tax expense	3,078	4,071
Bank levy	2,621	2,388
Net foreign exchange gain	(191)	(80)
Net gain on financial instruments	459	(2,194)
Changes in provisions for unearned premiums and claims	1,578	2,097
Depreciation and amortization	1,737	1,555
Share of profit of associates and net impairment	(18)	917
Investment property, fair value change	(397)	(1,366)
Revised Depositors' and Investors' Guarantee Fund expense	-	(2,669)
Discontinued operations, net of tax	(112)	-
Net gain from assets held for sale, net of tax	-	(616)
Other changes	(1)	-
Non-cash items included in net earnings	**(10,238)**	**(17,205)**

Changes in operating assets and liabilities

Mandatory reserve deposit with Central Bank	(1,190)	56
Loans to credit institutions, excluding bank accounts	(22,949)	2,373
Loans to customers	(46,453)	(33,882)
Financial instruments and financial liabilities at fair value	(3,603)	4,232
Investment property	(34)	(164)
Other assets	519	2,278
Due to credit institutions and Central Bank	8,153	(1,149)
Deposits	12,808	27,133
Borrowings	32,162	47,769
Other liabilities	1,333	(1,424)
Changes in operating assets and liabilities	**(19,254)**	**47,222**

Cash and cash equivalents

Cash and balances with Central Bank	99,525	132,316
Bank accounts	62,817	63,429
Mandatory reserve deposit with Central Bank	(10,414)	(9,276)
Cash and cash equivalents	**151,928**	**186,469**

The Notes on pages 16 to 75 are an integral part of these Condensed Consolidated Interim Financial Statements

Amounts are in ISK millions

Reconciliation of Consolidated Statement of Financial Position

Transition from IAS 39 to IFRS 9 as at 1 January 2018

Reconciliation of the Consolidated Statement of Financial Position carrying amounts under IAS 39 to the Consolidated Statement of Financial Position carrying amounts under IFRS 9 on 1 January 2018

	IAS 39 31.12.2017	Impact of classification and measurement	Impact of impairment	**Total impact**	IFRS 9 1.1.2018
Assets					
Cash and balances with Central Bank	139,819	-	(7)	(7)	139,812
Loans to credit institutions	86,609	-	(3)	(3)	86,606
Loans to customers	765,101	486	930	1,416	766,517
Financial instruments	109,450	-	-	-	109,450
Investment property	6,613	-	-	-	6,613
Investments in associates	760	-	-	-	760
Intangible assets	13,848	-	-	-	13,848
Tax assets	450	-	-	-	450
Non-current assets and disposal groups held for sale	8,138	-	-	-	8,138
Other assets	16,966	-	-	-	16,966
Total Assets	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**
Liabilities					
Due to credit institutions and Central Bank	7,370	-	-	-	7,370
Deposits	462,161	-	-	-	462,161
Financial liabilities at fair value	3,601	-	-	-	3,601
Tax liabilities	6,828	97	138	235	7,063
Other liabilities	57,062	-	229	229	57,291
Borrowings	384,998	-	-	-	384,998
Total Liabilities	**922,020**	**97**	**367**	**464**	**922,484**
Equity					
Share capital and share premium	75,861	-	-	-	75,861
Other reserves	16,774	-	3	3	16,777
Retained earnings	132,971	389	550	939	133,910
Total Shareholders' Equity	**225,606**	**389**	**553**	**942**	**226,548**
Non-controlling interest	128	-	-	-	128
Total Equity	**225,734**	**389**	**553**	**942**	**226,676**
Total Liabilities and Equity	**1,147,754**	**486**	**920**	**1,406**	**1,149,160**

Amounts are in ISK millions

Financial assets and Financial liabilities classification
Transition from IAS 39 to IFRS 9

Original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities on 1 January 2018

Financial assets	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount under IAS 39	Reclassi-fication	Re-measure-ment	Carrying amount under IFRS 9
Cash and balances with Central Bank ..	*Loans*	*Amortized cost*	139,819	-	(7)	139,812
Loans to credit institutions	*Loans*	*Amortized cost*	86,609	-	(3)	86,606
Loans to customers			765,101	486	930	766,517
Overdrafts	*Loans*	*Amortized cost*	*30,942*	-	*(50)*	*30,892*
Credit cards	*Loans*	*Amortized cost*	*12,040*	-	*(11)*	*12,029*
Mortgage loans	*Loans*	*Amortized cost*	*329,735*	-	*276*	*330,011*
Other loans	*Loans*	*Amortized cost*	*386,606*	-	*715*	*387,321*
Other loans	*Loans*	*FVTPL (mandatory)*	*5,778*	*486*	-	*6,264*
Financial instruments			109,450	-	-	109,450
Bonds and debt instruments	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*11,347*	-	-	*11,347*
Bonds and debt instruments	*FVTPL (designated)*	*FVOCI**	*40,408*	-	-	*40,408*
Shares and equity instruments	*FVTPL (designated)*	*FVTPL (mandatory)*	*36,190*	-	-	*36,190*
Derivatives	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*7,624*	-	-	*7,624*
Securities used for hedging	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*13,881*	-	-	*13,881*
Other financial assets	*Amortized cost*	*Amortized cost*	*8,948*	-	-	*8,948*
Total financial assets			**1,109,927**	**486**	**920**	**1,111,333**

Financial liabilities	Measurement category under IAS 39	Measurement category under IFRS 9	Carrying amount under IAS 39	Reclassi-fication	Re-measure-ment	Carrying amount under IFRS 9
Due to credit institutions and CB	*Amortized cost*	*Amortized cost*	7,370	-	-	7,370
Deposits	*Amortized cost*	*Amortized cost*	462,161	-	-	462,161
Financial liabilities at fair value	*FVTPL (held for trading)*	*FVTPL (mandatory)*	3,601	-	-	3,601
Other liabilities			34,705	-	229	34,934
Accounts payable	*Amortized cost*	*Amortized cost*	*26,394*	-	-	*26,394*
Unsettled securities trading	*FVTPL (held for trading)*	*FVTPL (mandatory)*	*527*	-	-	*527*
Depositors and investors guarantee fund	*Amortized cost*	*Amortized cost*	*218*	-	-	*218*
Withholding tax	*Amortized cost*	*Amortized cost*	*1,414*	-	-	*1,414*
Sundry financial liabilities	*Amortized cost*	*Amortized cost*	*6,152*	-	*229*	*6,381*
Borrowings	*Amortized cost*	*Amortized cost*	384,998	-	-	384,998
Total financial liabilities			**892,835**	**-**	**229**	**893,064**

Other liabilities						
Tax liabilities	*Amortized cost*	*Amortized cost*	*6,828*	*97*	*138*	7,063

*Treasury bonds previously designated at fair value through profit and loss under IAS 39, will be held at fair value through OCI under IFRS 9.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

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Notes to the Condensed Consolidated Interim Financial Statements

General information

Arion banki hf., the Parent Company, was established 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion banki hf. is located at Borgartún 19, Reykjavík. The Condensed Consolidated Interim Financial Statements for the period ended 30 September 2018 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

Statement of compliance

The Condensed Consolidated Interim Financial Statements have been prepared in accordance with International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the European Union and additional requirements in the Icelandic Financial Statements Act, Financial Undertakings Act and rules on Accounting for Credit Institutions. The Condensed Consolidated Interim Financial Statements do not include all the information and disclosures required in the Annual Financial Statements, and should be read in conjunction with Arion Bank's Annual Financial Statements for the year ended 31 December 2017. The Annual Financial Statements are available at Arion Bank's website www.arionbanki.is.

The Condensed Consolidated Interim Financial Statements were approved and authorized for issue by the Board of Directors of Arion Bank on 31 October 2018.

The same accounting policies, presentation and methods of computation are followed in these Condensed Consolidated Interim Financial Statements as were applied in the Group's Consolidated Financial Statements for the year ended 31 December 2017. Amendments to IFRS effective for 2018 did not have a material effect on the Financial Statements for the period from 1 January to 30 September 2018 except for the adoption of IFRS 9 on 1 January 2018.

IFRS 9 replaces IAS 39 for annual periods on or after 1 January 2018. The Group elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting in accordance with IAS 39. The Group has not restated comparative information for 2017 for financial instruments in the scope of IFRS 9. Therefore, the comparative information for 2017 is reported under IAS 39 and is not comparable to the information presented for 2018. The net income of ISK 942 million arising from the adoption of IFRS 9 have been recognized directly in retained earnings as of 1 January 2018. For further information, see the overviews for the transition from IAS 39 to IFRS 9.

Basis of measurement

New classification and measurement categories for IFRS 9 have replaced the ones used under IAS 39. For further details on the accounting policy under IAS 39 see the Annual Financial Statements 2017. For further details on the accounting policy under IFRS 9, see Note 45. To view the effects of the changes on individual portfolios see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

Functional and presentation currency

The Condensed Consolidated Interim Financial Statements are presented in Icelandic krona (ISK), which is the Parent Company's functional currency, rounded to the nearest million, unless otherwise stated. At the end of the period the exchange rate of the ISK against USD was 110.76 and 128.70 for EUR (31.12.2017: USD 103.70 and EUR 124.52).

Comparative figures

In the Consolidated Interim Income Statement for the period ended 30 September 2018 net income from non-current assets held for sale is presented among other operating income. Prior to the fourth quarter of 2017 net income from non-current assets held for sale was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly by reducing discontinued operations, net of tax, by ISK 616 million for the first nine months of 2017 and ISK 196 million for the third quarter 2017, increasing other operating income by ISK 770 million for the first nine months of 2017 and ISK 245 million for the third quarter 2017, and increasing income tax by ISK 154 million for the first nine months of 2017 and ISK 49 million for the third quarter 2017. The effects on the Statement of Cash flow was a shift between Non-cash items included in net earnings and other adjustments and Changes in operating assets and liabilities of ISK 616 million for the first nine months of 2017 and ISK 196 million for the third quarter of 2017.

2. Significant accounting estimates and judgements in applying accounting policies

The preparation of the Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the reported amount of revenues, expenses, assets and liabilities, and the accompanying disclosures, as well as the disclosure of contingent liabilities. Uncertainty about these assumptions and estimates could result in outcomes that require a material adjustment to the carrying amount of assets or liabilities affected in future periods.

Notes to the Condensed Consolidated Interim Financial Statements

3. The Group

Shares in the main subsidiaries in which Arion Bank held a direct interest at the end of the period

			Equity interest	
	Operating activity	Currency	30.9.2018	31.12.2017
Arion Bank Mortgages Instit. Investor Fund, Borgartún 19, Reykjavík, Iceland ...	Retail banking	ISK	100.0%	100.0%
BG12 slhf., Katrínartún 2, Reykjavík, Iceland ...	Holding company	ISK	62.0%	62.0%
EAB 1 ehf., Borgartún 19, Reykjavík, Iceland ...	Holding company	ISK	30.0%	100.0%
Eignarhaldsfélagid Landey ehf., Ögurhvarf 4a, Kópavogur, Iceland ...	Real estate	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland ...	Asset management	ISK	100.0%	100.0%
Valitor Holding hf., Dalshraun 3, Hafnarfjördur, Iceland ...	Payment solutions	ISK	100.0%	100.0%
VISA Ísland ehf., Dalshraun 3, Hafnarfjördur, Iceland ...	Holding company	ISK	100.0%	-
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland ...	Insurance	ISK	100.0%	100.0%

In addition the Bank holds the subsidiary Eignabjarg ehf. which is classified as Non-current assets and disposal groups held for sale, see Note 28.

The subsidiary EAB 1 ehf. had two classes of share capital. Arion Bank held 100% of the shareholding in class B until June 2018 when the class was settled. The remaining shareholding of Arion Bank is 30% in class A but Arion Bank controls the entity and thus it is classified as a subsidiary of the Bank.

In March 2018 the Bank acquired Valitor's 100% shareholding in VISA Ísland ehf. Combinations of entities under common control, i.e. transactions in which all the combining entities are under the control of the Group both before and after the combination, and that control is not transitory, are outside the scope of the IFRS 3 business combinations. Currently, there is no specific guidance for these transactions under IFRS, therefore, as permitted by IAS 8 accounting policies, changes in accounting and errors, the Group has developed an accounting policy considering pronouncements of other standard-setting bodies. The assets and liabilities recognized as a result of transactions between entities under common control are recognized at the carrying value on the transferor's financial statements.

In 2017 the Bank's subsidiary Valitor Holding hf. acquired two companies: IPS - International Payment Services Ltd. and Chip and Pin Solutions Ltd. The purpose of the acquisition is to strengthen Valitor's direct channel market position in the UK as the focus has been on partnerships in that market until now. Further information on intangible assets related to those two companies is contained in Note 26. The transactions are as follows:

Purchase price, paid in cash ...	2,123
Asset and liabilities of IPS and Chip and Pin at fair value:	
Loans to credit institutions (Bank accounts) ...	127
Other assets (Accounts receivables) ...	758
Other assets (Property and equipment) ...	21
Intangible assets, other than goodwill ...	404
Other liabilities (Accounts payable) ...	(960)
Fair value of asset and liabilities ...	350
Calculated goodwill ...	1,773

On 1 January 2017 Vördur tryggingar hf. acquired the Bank's 100% shareholding in Okkar líftryggingar hf. Following the acquisition Vördur tryggingar merged its two life insurance subsidiaries under the name of Vördur líftryggingar hf. The transaction was defined as combination of entities under common control.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Operating segment reporting

Segment information is presented in respect of the Group's operating segments and is based on the Group's management and internal reporting structure. Segment performance is evaluated based on earnings before tax. In presenting the geographic information, segment revenue has been based on the geographic location of customers or assets.

Inter segment pricing is determined on an arm's length basis. Operating segments pay and receive interest to and from Treasury on an arm's length basis to reflect the allocation of capital, funding cost and relevant risk premium.

Operating segments

The Group comprises the following operating segments:

Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition the division is the main distributor of funds managed by Stefnir hf. to individuals, companies and institutional investors and also distributes funds managed by international fund management companies. Asset Management also administers pension funds. Stefnir hf. is an independently operating financial company owned by Arion Bank. Stefnir manages a broad range of mutual funds, investment funds and institutional investor funds.

Corporate Banking services larger corporate clients, both in Iceland and abroad. Experienced account managers specializing in key economic sectors such as retail and services, seafood, energy and real estate are responsible for conducting larger transactions and developing strong business relationships with clients. The division provides a full range of lending products such as guarantees, deposit accounts, payment solutions and a variety of value-added digital solutions to meet the needs of the Bank's larger corporate clients. The Corporate Banking portfolio includes several larger international transactions, mainly in syndicates with other Icelandic banks and international banks.

Investment Banking comprises Corporate Finance, Capital Markets and Research. Investment Banking is a leading Icelandic brokerage house and financial advisor, providing a full and diverse range of investment banking services to a broad range of customers. Corporate Finance offers various financial advisory and capital raising services including M&A and financial restructuring advice and IPO management services. Capital Markets is a leading securities and foreign exchange brokerage and provides clients with a diverse range of fixed income services and risk management products. Research is an independent research team producing in-depth analysis of the Icelandic economy and financial markets.

Retail Banking, including Arion Bank Mortgages Institutional Investor Fund, provides a comprehensive range of products and services, including mortgage loans, savings and checking accounts, vehicle and equipment financing, factoring, payment cards, pension services, insurance and funds, to both individuals and SMEs. Retail Banking has a strong focus on digital banking solutions, including internet banking, the Arion Bank app and automated teller machines. As of 30 September 2018, Retail Banking operated out of 21 branches across Iceland over 100,000 customers during the year.

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Other functions of Treasury are funds' transfer pricing and hedging and pricing of financial products.

Subsidiaries and other divisions include the subsidiaries Valitor Holding hf., Vördur tryggingar hf., Eignarhaldsfélagid Landey ehf., VISA Ísland ehf., EAB 1 ehf., BG12 slhf. and other smaller entities of the Group and Market Making in domestic securities and currencies. Due to the relative proportion of the subsidiary Valitor Holding hf. in the operation of the Group, financial information for Valitor is reported separately in the disclosure for the operating segments.

In addition to the above operating segments, the Group presents information for units at the corporate headquarters which carry out support functions such as Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. The information presented relating to the headquarters does not represent an operating segment. A significant proportion of expenses from support functions is allocated to operating segments in a separate line in the operating segment overview, see Note 4.

Notes to the Condensed Consolidated Interim Financial Statements

4. Operating segments

1.1.-30.9.2018	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi- aries and Other divisions	Head- quarters and Elimination	Total
Net interest income	506	4,215	204	13,029	3,295	823	(106)	21,966
Net fee and commission income	2,568	825	1,331	3,653	(232)	3,996	139	12,280
Net financial income	69	(147)	(4)	-	742	1,639	550	2,849
Net insurance income	-	-	-	-	-	1,919	(34)	1,885
Share of profit of associates and net impairment	-	-	-	3	-	-	15	18
Other operating income	16	2	-	519	-	650	123	1,310
Operating income	3,159	4,895	1,531	17,204	3,805	9,027	687	40,308
Operating expense	(1,123)	(366)	(635)	(5,075)	(153)	(7,479)	(10,761)	(25,592)
Allocated expense	(623)	(2,147)	(498)	(4,735)	(761)	(6)	8,770	-
Bank levy	(129)	(538)	(36)	(919)	(999)	-	-	(2,621)
Net impairment	-	(3,461)	16	494	-	(17)	(1)	(2,969)
Earnings (loss) before tax	1,284	(1,617)	378	6,969	1,892	1,525	(1,305)	9,126
Net seg. rev. from ext. customers	1,141	12,215	1,273	27,318	(11,878)	9,440	799	40,308
Net seg. rev. from other segments	2,018	(7,320)	258	(10,114)	15,683	(413)	(112)	-
Operating income	3,159	4,895	1,531	17,204	3,805	9,027	687	40,308
Depreciation and amortization	1	3	1	279	-	879	574	1,737
Total assets	76,371	283,734	17,796	577,633	531,876	94,739	(362,620)	1,219,529
Total liabilities	71,449	222,966	17,225	502,716	511,646	60,416	(366,945)	1,019,473
Allocated equity	4,922	60,768	571	74,917	20,230	34,323	4,325	200,056

1.1.-30.9.2017	Asset Manage- ment	Corporate Banking	Investment Banking	Retail Banking	Treasury	Subsidi- aries and Other divisions	Head- quarters and Elimination	Total
Net interest income	399	4,777	182	11,818	4,626	941	(173)	22,570
Net fee and commission income	2,643	771	928	3,406	(248)	2,921	282	10,703
Net financial income	121	245	(59)	19	(340)	3,354	(869)	2,471
Net insurance income	-	-	-	-	-	1,833	(64)	1,769
Share of profit of associates and net impairment	-	-	-	-	-	4	(921)	(917)
Other operating income	17	1,075	-	800	5	619	342	2,858
Operating income (loss)	3,180	6,868	1,051	16,043	4,043	9,672	(1,403)	39,454
Operating expense	(753)	(239)	(558)	(3,319)	209	(6,585)	(10,135)	(21,380)
Allocated expense	(740)	(1,740)	(470)	(4,288)	(626)	(10)	7,874	-
Bank levy	(215)	(475)	(28)	(917)	(753)	-	-	(2,388)
Net impairment	-	(2,436)	(18)	1,206	55	(70)	1	(1,262)
Earnings (loss) before tax	1,472	1,978	(23)	8,725	2,928	3,007	(3,663)	14,424
Net seg. rev. from ext. customers	1,581	12,028	684	23,119	(6,931)	10,197	(1,224)	39,454
Net seg. rev. from other segments	1,599	(5,160)	367	(7,076)	10,974	(525)	(179)	-
Operating income (loss)	3,180	6,868	1,051	16,043	4,043	9,672	(1,403)	39,454
Depreciation and amortization	1	-	-	268	-	702	584	1,555
Total assets	123,297	272,670	16,344	527,181	432,846	92,005	(319,491)	1,144,852
Total liabilities	118,604	216,137	15,044	461,541	375,975	60,813	(324,971)	923,143
Allocated equity	4,693	56,533	1,300	65,640	56,871	31,192	5,480	221,709

Income taxes and discontinued operations are excluded from the profit and loss segment information. From prior periods additional line of allocated expense from supporting divisions to business segments has been added. Those supporting divisions are Overhead, Risk Management, Finance (excluding Treasury and Market Making), Legal and IT. Bank levy has also been allocated to business segments. Comparative figures for 2017 have been updated accordingly.

Amounts are in ISK millions

4. Operating segments, continued

Subsidiaries and other divisions

	2018 1.1.-30.9.			2017 1.1.-30.9.		
	Valitor	Other	Total	Valitor	Other	Total
Net interest income	645	178	823	793	148	941
Net fee and commission income	4,078	(82)	3,996	3,148	(227)	2,921
Net financial income	(144)	1,783	1,639	2,107	1,247	3,354
Net insurance income	-	1,919	1,919	-	1,833	1,833
Share of profit of associates and net impairment	-	-	-	-	4	4
Other operating income	180	470	650	278	341	619
Operating income	4,759	4,268	9,027	6,326	3,346	9,672
Operating expense	(5,913)	(1,566)	(7,479)	(4,929)	(1,656)	(6,585)
Allocated expense	-	(6)	(6)	-	(10)	(10)
Net impairment	(17)	-	(17)	(70)	-	(70)
Earnings (loss) before tax	(1,171)	2,696	1,525	1,327	1,680	3,007
Net seg. rev. from ext. customers	5,333	4,325	9,658	6,872	3,341	10,213
Net seg. rev. from other segments	(574)	(57)	(631)	(546)	5	(541)
Operating income	4,759	4,268	9,027	6,326	3,346	9,672
Depreciation and amortization	781	99	880	605	97	702
Total assets	43,089	51,650	94,739	48,581	43,424	92,005
Total liabilities	27,661	32,755	60,416	31,981	28,832	60,813
Allocated equity	15,428	18,895	34,323	16,600	14,592	31,192

Geographic information

1.1.-30.9.2018	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	23,938	409	350	(2,730)	(27)	26	21,966
Net fee and commission income	9,672	598	1,212	777	18	3	12,280
Net financial income	2,224	(30)	590	66	(1)	-	2,849
Net insurance income	1,885	-	-	-	-	-	1,885
Share of profit of associates and net impairment	18	-	-	-	-	-	18
Other operating income	1,310	-	-	-	-	-	1,310
Operating income (loss)	39,047	977	2,152	(1,887)	(10)	29	40,308

1.1.-30.9.2017	Iceland	Nordic	United Kingdom	Other Europe	North America	Other	Total
Net interest income	24,955	306	176	(3,226)	323	36	22,570
Net fee and commission income	8,778	183	184	1,540	14	4	10,703
Net financial income	1,126	(11)	240	224	883	9	2,471
Net insurance income	1,769	-	-	-	-	-	1,769
Share of profit of associates and net impairment	(917)	-	-	-	-	-	(917)
Other operating income	2,858	-	-	-	-	-	2,858
Operating income (loss)	38,569	478	600	(1,462)	1,220	49	39,454

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Quarterly statements

5. Operations by quarters

2018	Q3	Q2	Q1	Total
Net interest income	7,445	7,613	6,908	21,966
Net fee and commission income	4,246	4,492	3,542	12,280
Net financial income	582	927	1,340	2,849
Net insurance income	984	758	143	1,885
Share of profit of associates and net impairment	34	2	(18)	18
Other operating income	431	610	269	1,310
Operating income	13,722	14,402	12,184	40,308
Salaries and related expense	(4,168)	(5,011)	(4,636)	(13,815)
Other operating expense	(3,817)	(3,964)	(3,996)	(11,777)
Bank levy	(937)	(880)	(804)	(2,621)
Net impairment	(2,678)	(192)	(99)	(2,969)
Earnings before tax	2,122	4,355	2,649	9,126
Income tax expense	(973)	(1,287)	(818)	(3,078)
Net earnings from continuing operations	1,149	3,068	1,831	6,048
Discontinued operations, net of tax	-	(6)	118	112
Net earnings	1,149	3,062	1,949	6,160

2017				
Net interest income	7,250	8,160	7,160	22,570
Net fee and commission income	3,865	3,508	3,330	10,703
Net financial income	(734)	1,975	1,230	2,471
Net insurance income	716	606	447	1,769
Share of profit of associates and net impairment	17	(900)	(34)	(917)
Other operating income	483	1,811	564	2,858
Operating income	11,597	15,160	12,697	39,454
Salaries and related expense	(3,841)	(4,561)	(4,222)	(12,624)
Other operating expense	(3,699)	(1,223)	(3,834)	(8,756)
Bank levy	(814)	(777)	(797)	(2,388)
Net impairment	(2,551)	409	880	(1,262)
Earnings before tax	692	9,008	4,724	14,424
Income tax expense	(805)	(1,895)	(1,371)	(4,071)
Net earnings from continuing operations	(113)	7,113	3,353	10,353
Discontinued operations, net of tax	-	-	-	-
Net earnings	(113)	7,113	3,353	10,353

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Consolidated Interim Income Statement

6. Net interest income

	2018 1.1.-30.9.				2017 1.1.-30.9.
Interest income	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total	
Cash and balances with Central Bank	3,734	-	-	3,734	5,059
Loans	38,597	250	-	38,847	35,963
Securities	-	208	247	455	1,624
Other	616	-	-	616	642
Interest income	42,947	458	247	43,652	43,288
Interest expense					
Deposits	(9,794)	-	-	(9,794)	(9,746)
Borrowings	(11,784)	-	-	(11,784)	(10,912)
Other	(108)	-	-	(108)	(60)
Interest expense	(21,686)	-	-	(21,686)	(20,718)
Net interest income	21,261	458	247	21,966	22,570
Net interest income from financial assets and liabilities at fair value	-	458	247	705	1,624
Interest income from financial assets at amortized cost	42,947	-	-	42,947	41,664
Interest expense from financial liabilities at amortized cost	(21,686)	-	-	(21,686)	(20,718)
Net interest income	21,261	458	247	21,966	22,570

	2018 1.7.-30.9.				2017 1.7.-30.9.
Interest income	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total	
Cash and balances with Central Bank	1,311	-	-	1,311	1,653
Loans	13,460	179	-	13,639	11,155
Securities	-	(17)	40	23	427
Other	209	-	-	209	213
Interest income	14,980	162	40	15,182	13,448
Interest expense					
Deposits	(3,426)	-	-	(3,426)	(2,804)
Borrowings	(4,240)	-	-	(4,240)	(3,379)
Other	(71)	-	-	(71)	(15)
Interest expense	(7,737)	-	-	(7,737)	(6,198)
Net interest income	7,243	162	40	7,445	7,250
Net interest income from financial assets and liabilities at fair value	-	162	40	202	427
Interest income from financial assets at amortized cost	14,980	-	-	14,980	13,021
Interest expense from financial liabilities at amortized cost	(7,737)	-	-	(7,737)	(6,198)
Net interest income	7,243	162	40	7,445	7,250

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.7%	2.9%	2.7%	2.7%

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

7. Net fee and commission income

	2018 1.1.-30.9.			2017 1.1.-30.9.		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	2,945	(332)	2,613	3,024	(300)	2,724
Cards and payment solution	17,200	(11,616)	5,584	13,517	(9,239)	4,278
Collection and payment services	1,188	(69)	1,119	1,174	(72)	1,102
Investment banking	936	(24)	912	627	(33)	594
Lending and financial guarantees	1,431	-	1,431	1,529	-	1,529
Other	1,089	(468)	621	1,010	(534)	476
Net fee and commission income	24,789	(12,509)	12,280	20,881	(10,178)	10,703

	2018 1.7.-30.9.			2017 1.7.-30.9.		
Asset management	930	(107)	823	971	(91)	880
Cards and payment solution	4,267	(2,363)	1,904	5,298	(3,690)	1,608
Collection and payment services	414	(22)	392	426	(23)	403
Investment banking	380	(6)	374	199	(9)	190
Lending and guarantees	481	-	481	582	-	582
Other	411	(139)	272	386	(184)	202
Net fee and commission income	6,883	(2,637)	4,246	7,862	(3,997)	3,865

Asset management fees are earned by the Group on trust and fiduciary activities where the Group holds or invests assets on behalf of the customers.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

8. Net financial income

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,983	-	210	-
Net gain on fair value hedge of interest rate swap	527	178	154	123
Realized gain on financial assets carried at fair value through OCI*	148	-	8	-
Net gain on financial assets and financial liabilities classified as held for trading (IAS 39)	-	(90)	-	(130)
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	2,303	-	(808)
Net foreign exchange gain (loss)	191	80	210	81
Net financial income	2,849	2,471	582	(734)

Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss

Equity instruments mandatorily measured at fair value	1,820	-	(25)	-
Debt instruments mandatorily measured at fair value	196	-	102	-
Derivatives	(29)	-	65	-
Loans	(4)	-	68	-
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	1,983	-	210	-

Net gain on fair value hedge of interest rate swap

Fair value change of interest rate swaps designated as hedging instruments	325	(274)	(393)	238
Fair value change on bonds issued by the Group attributable to interest rate risk	202	452	547	(115)
Net gain on fair value hedge of interest rate swap	527	178	154	123

Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)

Equity instruments designated at fair value	-	2,347	-	(342)
Interest rate instruments designated at fair value	-	(44)	-	(466)
Net gain on financial assets and financial liabilities designated at fair value through profit or loss (IAS 39)	-	2,303	-	(808)

*Realized gain on financial assets carried at fair value through OCI comprises gain previously recognized in the Income Statement under IAS 39. With the adoption of IFRS 9 1 January 2018 the total amount of unrealized gain on financial assets carried at fair value through OCI, net of tax was transferred to reserve for financial instruments carried at fair value, net of tax, see Note 33. Upon disposal realized gain on financial assets carried at fair value through OCI was transferred to the Income Statement in accordance with IFRS 9, as the Bank elected not to restate comparative figures.

9. Net insurance income

Earned premiums, net of reinsurers' share	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Premiums written	8,777	8,443	2,396	2,179
Premiums written, reinsurers' shares	(255)	(308)	(77)	(104)
Change in provision for unearned premiums	(925)	(1,334)	319	318
Change in provision for unearned premiums, reinsurers' share	-	1	-	-
Earned premiums, net of reinsurers' share	7,597	6,802	2,638	2,393

Claims incurred, net of reinsurers' share

Claims paid	(5,132)	(4,347)	(1,628)	(1,438)
Claims paid, reinsurers' share	73	78	16	24
Change in provision for claims	(642)	(749)	(35)	(246)
Changes in provision for claims, reinsurers' share	(11)	(15)	(7)	(17)
Claims incurred, net of reinsurers' share	(5,712)	(5,033)	(1,654)	(1,677)
Net insurance income	1,885	1,769	984	716

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

10. Other operating income

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Fair value changes on investment property	397	1,366	14	4
Realized gain on investment property	-	15	-	4
Net gain on non-current assets held for sale	512	770	360	245
Other income	401	707	57	230
Other operating income	1,310	2,858	431	483

Net gain on non-current assets held for sale

Income from real estates and other assets	660	966	414	311
Expense related to real estates and other assets	(148)	(196)	(54)	(66)
Net gain on non-current assets held for sale	512	770	360	245

Net gain on non-current assets held for sale are classified as other operating income in these Condensed Consolidated Interim Financial Statements. In prior years it was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

11. Personnel and salaries

Number of employees	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Average number of full-time equivalent positions during the period	1,305	1,235	1,311	1,275
Full-time equivalent positions at the end of the period	1,334	1,293	1,334	1,293
Number of employees at the parent company				
Average number of full-time equivalent positions during the period	824	826	810	824
Full-time equivalent positions at the end of the period	822	842	822	842
Salaries and related expense				
Salaries	11,242	10,125	3,426	3,056
Defined contribution pension plans	1,602	1,441	487	431
Salary-related expense	1,441	1,312	432	430
Capitalization of salaries, due to internally developed software	(470)	(254)	(177)	(76)
Salaries and related expense	13,815	12,624	4,168	3,841
Salaries and related expense for Arion Bank				
Salaries	7,249	6,832	2,104	2,063
Defined contribution pension plans	1,033	973	299	291
Salary-related expense	1,080	1,004	315	307
Salaries and related expense	9,362	8,809	2,718	2,661

In June 2018 Arion Bank adopted a new share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company in connection with the IPO and listing of the Bank. Remuneration is paid in the form of deferred shares with a vesting period of two years. The aim of the remuneration programme is to build long-term engagement among employees through share ownership. The Bank recognizes expenses related to the programme as salaries and related expenses, a total of ISK 651 million, over the vesting period, or approximately ISK 81 million each quarter. The market value of shares at granting date was ISK 295 million, which was deducted from the Bank's own shares.

During the period the Group made a provision of ISK 367 million (9M 2017: ISK 406 million) for performance plan payments, including salary-related expense, of which the Bank made a provision of ISK 317 million (9M 2017: ISK 338 million). Forty percent of the payment is deferred for three years in accordance with FME rules on remuneration policy for Financial Undertakings. At the end of the period the Group's accrual for performance plan payments amounted to ISK 911 million (31.12.2017: ISK 942 million), of which the Bank's accrual amounts to ISK 752 million (31.12.2017: ISK 762 million).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

12. Other operating expense

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Administration expense	9,373	9,182	3,002	2,940
Depositors' and Investors' Guarantee Fund	639	(2,045)	218	213
Depreciation of property and equipment	623	613	203	200
Amortization of intangible assets	1,114	942	388	332
Other expense	28	64	6	14
Other operating expense	11,777	8,756	3,817	3,699

The Bank had recognized a liability of ISK 2,669 million against the Depositors' and Investors' Guarantee Fund. At the end of June 2017 the Bank received confirmation from the Fund stating that the claim would not be collected.

13. Bank levy

The Bank levy is 0.376% on total debts excluding tax liabilities, in excess of ISK 50 billion. The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

14. Net impairment

	2018 1.1.-30.9.	2018 1.7.-30.9.
Net change in impairment of cash and balances with Central Bank	5	-
Net change in impairment of loans to credit institutions	(35)	(5)
Net change in impairment of loans to corporates	(2,309)	(1,110)
Net change in impairment of loans to individuals	316	(44)
Net change in impairment of financial instruments carried at fair value through OCI, net of tax	(4)	12
Net change in impairment of loan commitments, guarantees and unused credit facilities	(1,770)	(1,711)
Net impairment on financial instruments	(3,797)	(2,858)
Increase in book value of loans to corporates	49	16
Increase in book value of loans to individuals	779	164
Other value changes of loans	828	180
Net impairment	(2,969)	(2,678)

Net impairment under IAS 39	2017 1.1.-30.9.	2017 1.7.-30.9.
Net change in impairment of loans to corporates	(3,215)	(3,519)
Net change in impairment of loans to individuals	(131)	50
Net change in collective impairment on loans	607	522
Provision for losses	(2,739)	(2,947)
Increase in book value of loans to corporates	347	9
Increase in book value of loans to individuals	1,130	387
Net impairment	(1,262)	(2,551)

Amounts are in ISK millions

15. Income tax expense

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Current tax expense	2,992	4,441	747	738
Deferred tax expense	86	(370)	226	67
Income tax expense	3,078	4,071	973	805

Reconciliation of effective tax rate	2018 1.1.-30.9.		2017 1.1.-30.9.	
Earnings before tax		9,126		14,424
Income tax using the Icelandic corporate tax rate	20.0%	1,825	20.0%	2,885
Additional 6% tax on Financial Undertakings	6.3%	577	6.4%	909
Non-deductible expenses	0.1%	6	0.0%	7
Tax exempt revenue	(2.8%)	(252)	(1.8%)	(257)
Non-deductible taxes	5.7%	524	3.4%	478
Tax incentives not recognized in the Income Statement	4.4%	406	(0.1%)	(12)
Other changes	(0.1%)	(8)	0.4%	61
Effective tax rate	33.7%	3,078	28.2%	4,071

Financial undertakings pay 6% additional tax on taxable profit exceeding ISK 1 billion.

Tax exempt revenues consist mainly of profit from equity positions.

16. Discontinued operations, net of tax

	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Income from discontinued operations	140	-	-	-
Income tax expense	(28)	-	-	-
Discontinued operations, net of tax	112	-	-	-

Net gain on non-current assets held for sale are classified as other operating income in these Condensed Consolidated Interim Financial Statements. Prior to the fourth quarter of 2017 it was classified as discontinued operations, net of tax. Comparative figures have been changed accordingly, see Note 1.

17. Earnings per share

	Continued operations		Discontinued operations		Continued and discontinued operations	
	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.1.-30.9.	2017 1.1.-30.9.	2018 1.1.-30.9.	2017 1.1.-30.9.
Net earnings attributable to the shareholders of Arion Bank	5,437	10,351	112	-	5,549	10,351
Weighted average number of outstanding shares for the period, million	1,851	2,000	1,851	2,000	1,851	2,000
Basic earnings per share	2.94	5.18	0.06	-	3.00	5.18

	2018 1.7.-30.9.	2017 1.7.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.	2018 1.7.-30.9.	2017 1.7.-30.9.
Net earnings attributable to the shareholders of Arion Bank	1,151	(113)	-	-	1,151	(113)
Weighted average number of outstanding shares for the period, million	1,814	2,000	1,814	2,000	1,814	2,000
Basic earnings per share	0.63	(0.06)	-	-	0.63	(0.06)

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2017: none).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Notes to the Condensed Consolidated Interim Statement of Financial Position

18. Cash and balances with Central Bank

	30.9.2018	31.12.2017
Cash on hand	10,103	9,954
Cash with Central Bank	79,008	120,641
Mandatory reserve deposit with Central Bank	10,414	9,224
Cash and balances with Central Bank	99,525	139,819

The mandatory reserve deposit with the Central Bank is not available for the Group to use in its daily operations.

19. Loans to credit institutions

	30.9.2018	31.12.2017
Bank accounts	62,817	51,303
Money market loans	57,113	32,309
Other loans	3,516	2,997
Loans to credit institutions	123,446	86,609

20. Loans to customers

	Individuals		Corporates		Total	
30.9.2018	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	15,783	14,727	18,101	17,099	33,884	31,826
Credit cards	11,585	11,354	1,270	1,237	12,855	12,591
Loans to customers at fair value	-	-	6,344	6,344	6,344	6,344
Mortgage loans	338,059	337,401	22,598	22,559	360,657	359,960
Other loans	36,351	34,179	381,955	375,065	418,306	409,244
Loans to customers	401,778	397,661	430,268	422,304	832,046	819,965
31.12.2017						
Overdrafts	14,469	13,438	18,778	17,504	33,247	30,942
Credit cards	11,133	10,931	1,123	1,109	12,256	12,040
Mortgage loans	311,507	310,318	19,632	19,417	331,139	329,735
Other loans	33,629	30,600	368,312	361,784	401,941	392,384
Loans to customers	370,738	365,287	407,845	399,814	778,583	765,101

The total book value of pledged loans that were pledged against amounts borrowed was ISK 193 billion at the end of the period (31.12.2017: ISK 183 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk Management Disclosures.

21. Financial instruments

	30.9.2018	31.12.2017
Bonds and debt instruments	64,256	51,755
Shares and equity instruments with variable income	21,348	36,190
Derivatives	6,353	7,624
Securities used for economic hedging	17,417	13,881
Financial instruments	109,374	109,450

Amounts are in ISK millions

22. Financial assets and financial liabilities

30.9.2018 **Financial assets**	Amortized cost	Fair value through OCI	Manda-torily at fair value through P/L	Total
Loans				
Cash and balances with Central Bank	99,525	-	-	99,525
Loans to credit institutions	123,446	-	-	123,446
Loans to customers	813,621	-	6,344	819,965
Loans	1,036,592	-	6,344	1,042,936
Bonds and debt instruments				
Listed	-	46,311	15,086	61,397
Unlisted	-	2,407	452	2,859
Bonds and debt instruments	-	48,718	15,538	64,256
Shares and equity instruments with variable income				
Listed	-	-	8,683	8,683
Unlisted	-	-	9,663	9,663
Bond funds with variable income, unlisted	-	-	3,002	3,002
Shares and equity instruments with variable income	-	-	21,348	21,348
Derivatives				
OTC derivatives	-	-	5,354	5,354
Derivatives used for hedge accounting	-	-	999	999
Derivatives	-	-	6,353	6,353
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	9,247	9,247
Shares and equity instruments with variable income, listed	-	-	8,167	8,167
Shares and equity instruments with variable income, unlisted	-	-	3	3
Securities used for economic hedging	-	-	17,417	17,417
Accounts receivable	5,915	-	-	5,915
Other financial assets	21,595	-	-	21,595
Financial assets	1,058,187	48,718	67,000	1,173,905
Financial liabilities				
Due to credit institutions and Central Bank	15,370	-	-	15,370
Deposits	484,569	-	-	484,569
Borrowings	425,601	-	-	425,601
Short position in bonds	-	-	1,020	1,020
Short position in equity	-	3	-	3
Derivatives	-	-	2,358	2,358
Other financial liabilities	56,313	-	-	56,313
Financial liabilities	981,853	3	3,378	985,234

For further information on the transition, reclassification and measurements at 1 January 2018, see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

Amounts are in ISK millions

22. Financial assets and financial liabilities, continued

31.12.2017*

Financial assets	Amortized cost	Trading	Designated at fair value	Total
Loans				
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers	765,101	-	-	765,101
Loans	991,529	-	-	991,529
Bonds and debt instruments				
Listed	-	2,452	46,638	49,090
Unlisted	-	23	2,642	2,665
Bonds and debt instruments	-	2,475	49,280	51,755
Shares and equity instruments with variable income				
Listed	-	1,677	5,380	7,057
Unlisted	-	1,303	10,397	11,700
Bond funds with variable income, unlisted	-	1,782	15,651	17,433
Shares and equity instruments with variable income	-	4,762	31,428	36,190
Derivatives				
OTC derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Derivatives	-	7,624	-	7,624
Securities used for economic hedging				
Bonds and debt instruments, listed	-	6,024	-	6,024
Shares and equity instruments with variable income, listed	-	7,846	-	7,846
Shares and equity instruments with variable income, unlisted	-	11	-	11
Securities used for economic hedging	-	13,881	-	13,881
Other financial assets	8,948	-	-	8,948
Financial assets	1,000,477	28,742	80,708	1,109,927
Financial liabilities				
Due to credit institutions and Central Bank	7,370	-	-	7,370
Deposits	462,161	-	-	462,161
Borrowings	384,998	-	-	384,998
Short position in bonds	-	1,467	-	1,467
Short position in equity	-	67	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Other financial liabilities	34,705	-	-	34,705
Financial liabilities	889,234	3,601	-	892,835

*Comparative figures have not been restated in accordance with IFRS 9.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

22. Financial assets and financial liabilities, continued

Bonds and debt instruments measured at fair value, specified by issuer

30.9.2018	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	2,949	5,573	8,522
Public sector	39,195	8,074	47,269
Corporates	6,574	1,891	8,465
Bonds and debt instruments at fair value	48,718	15,538	64,256

31.12.2017*	Trading	Designated at fair value	Total
Financial and insurance activities	1,575	4,415	5,990
Public sector	823	38,389	39,212
Corporates	77	6,476	6,553
Bonds and debt instruments designated at fair value	2,475	49,280	51,755

*Comparative figures have not been restated in accordance with IFRS 9.

The total amount of pledged bonds was ISK 5.7 billion at the end of the period (31.12.2017: ISK 13.4 billion). Pledged bonds comprised Icelandic and foreign Government bonds that were pledged against funding received and included in Due to credit institutions and Central Bank as well as short positions included in Financial liabilities at fair value.

23. Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of assets and liabilities by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities;
Level 2: valuation techniques for which all significant inputs are market observable, either directly or indirectly; and
Level 3: valuation techniques which include significant inputs that are not based on observable market data.

For assets and liabilities that are recognized at fair value on a recurring basis, the Group determines whether transfers have occurred between Levels in the hierarchy by re-assessing categorization (based on the lowest level input that is significant to the fair value measurement as a whole) at the end of each reporting period. On 1 January 2018 the Group implemented IFRS 9 and as a result of the implementation assets previously measured at amortized cost were reclassified to mandatorily measured at fair value through profit and loss. The reclassified assets are measured as Level 2 assets.

Assets and liabilities recorded at fair value by level of the fair value hierarchy

30.9.2018

Assets at fair value	Level 1	Level 2	Level 3	Total
Loans to customers	-	6,344	-	6,344
Bonds and debt instruments	54,412	9,803	41	64,256
Shares and equity instruments with variable income	5,104	15,094	1,150	21,348
Derivatives	-	5,354	-	5,354
Derivatives used for hedge accounting	-	999	-	999
Securities used for economic hedging	17,414	3	-	17,417
Investment property	-	-	7,044	7,044
Assets at fair value	76,930	37,597	8,235	122,762
Liabilities at fair value				
Short position in bonds	1,020	-	-	1,020
Derivatives	3	-	-	3
Derivatives used for hedge accounting	-	2,358	-	2,358
Liabilities at fair value	1,023	2,358	-	3,381

Amounts are in ISK millions

23. Fair value hierarchy, continued

31.12.2017

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	32,452	19,264	39	51,755
Shares and equity instruments with variable income	4,140	30,920	1,130	36,190
Derivatives	-	7,544	-	7,544
Derivatives used for hedge accounting	-	80	-	80
Securities used for economic hedging	13,713	168	-	13,881
Investment property	-	-	6,613	6,613
Assets at fair value	50,305	57,976	7,782	116,063

Liabilities at fair value	Level 1	Level 2	Level 3	Total
Short position in bonds	1,467	-	-	1,467
Short position in equity	67	-	-	67
Derivatives	-	1,722	-	1,722
Derivatives used for hedge accounting	-	345	-	345
Liabilities at fair value	1,534	2,067	-	3,601

Transfers from Level 2 to Level 1 amounted to ISK 767 million during the period due to listing of companies on Nasdaq Iceland (2017: No transfers).

Fair value of assets and liabilities

The fair value of asset and liabilities is the amount at which the asset and liability could be exchanged in a current transaction between willing parties, i.e. not during a forced sale or liquidation. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used by the Group to measure assets and liabilities. If quoted prices for an asset fail to represent actual and regularly occurring transactions in active market transactions or if quoted prices are not available at all, fair value is established by using an appropriate valuation technique.

Methods for establishing fair value

The best evidence of the fair value of an asset and liability at initial recognition is the transaction price, unless the fair value can be evidenced by comparison with other observable current market transactions, or is based on a valuation technique whose variables include only data from observable markets.

In some cases, the carrying value of an asset in Note 22 is used as an approximation for the fair value of the asset. This is straight forward for cash and cash equivalents but is also used for short term investments and borrowings to highly rated counterparties, such as credit institutions, on contracts that feature interest close to or equal to market rates and expose the Group to little or no credit risk.

Level 1: Fair value established from quoted market prices

For listed and liquid stocks and bonds, certain financial derivatives and other market traded securities, the fair value is derived directly from quoted market prices. These instruments are disclosed under Financial instruments and Financial liabilities at fair value in the Statement of Financial Position.

Level 2: Fair value established using valuation techniques with observable market information

For assets and liabilities, for which the market is not active, the Group applies valuation techniques to attain a fair value using as much market information as available. Valuation techniques include using recent market transactions between knowledgeable and willing parties, if available, reference to current fair value of another instrument that is substantially the same, discounted cash flow analysis, option pricing models or other commonly accepted valuation techniques used by market participants to price the instrument.

For assets and liabilities for which quoted prices on active markets are not available, the fair value is derived using various valuation techniques. This applies in particular to OTC derivatives such as options, swaps, futures and unlisted equities but also some other assets and liabilities.

In most cases the valuation is based on theoretical financial models, such as the Black Scholes model or variations thereof. These techniques also include forward pricing and swap models using present value calculations.

Level 2 instruments include unlisted shares, unlisted funds with underlying bonds and equity holdings (share certificates), unlisted and less liquid listed bonds and all OTC derivatives.

Amounts are in ISK millions

23. Fair value hierarchy, continued

Level 3: Fair value established using valuation techniques with significant unobservable market information

In many cases there is little or no market data to rely on for fair value calculations. The most common valuation technique is present value calculations. Such calculations involve the estimation of future cash flow and the assessment of appropriate discount rate. The discount rate should both reflect current market rates and the uncertainty in the future cash flow. In such cases internal models and methods are used to calculate the fair value. The models may be statistical in nature, based on internal or external history of assets with similar characteristics and/or based on internal knowledge and experience. For example, the credit margin on most loans to customers which, is added to the current and suitable interest rate to arrive at an appropriate discount rate, is estimated using credit rating and loss parameters in case of default that have been derived from internal models.

Equity instruments that do not have a quoted market price are evaluated using methods and guidelines from pertinent international organizations. In most cases intrinsic value is the basis for the assessment but other factors, such as cash flow analysis, can also modify the results.

The Group applies management valuation for determining fair value of investment properties. Management valuation is either based on recent transactions and offers for similar assets or present value calculations which involve estimation of future cash flow and the assessment of appropriate discount rate.

Movements in Level 3 assets measured at fair value

	Investment	Financial assets		
30.9.2018	property	Bonds	Shares	Total
Balance at the beginning of the year	6,613	39	1,130	7,782
Net fair value changes	397	7	(33)	371
Additions	29	-	120	149
Disposals	-	(5)	(1)	(6)
Transfers out of Level 3	5	-	(66)	(61)
Balance at the end of the period	7,044	41	1,150	8,235

31.12.2017				
Balance at the beginning of the year	5,358	89	18	5,465
Net fair value changes	1,036	(617)	23	442
Net gain from disposal	15	-	-	15
Additions	767	-	234	1,001
Disposal	(563)	(147)	(15)	(725)
Transfers into Level 3*	-	714	870	1,584
Balance at the end of the period	6,613	39	1,130	7,782

*In a routine review of the portfolio the Bank reclassified a number of unlisted shares and bonds from Level 2 to Level 3. Presumptions for classification to Level 2 were no longer considered available.

Line items where effects of Level 3 assets are recognized in the Consolidated Interim Income Statement

	Investment	Financial assets		
1.1.-30.9.2018	property	Bonds	Shares	Total
Net financial income	-	7	(33)	(26)
Other operating income	397	-	-	397
Effects recognized in the Income Statement	397	7	(33)	371

1.1.-30.9.2017				
Net interest income	-	27	-	27
Net financial income	-	(694)	24	(670)
Other operating income	1,381	-	-	1,381
Effects recognized in the Income Statement	1,381	(667)	24	738

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

23. Fair value hierarchy, continued

Carrying values and fair values of financial assets and financial liabilities not carried at fair value

30.9.2018	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	99,525	99,525	-
Loans to credit institutions	123,446	123,446	-
Loans to customers	819,965	822,797	2,832
Other financial assets	27,510	27,510	-
Financial assets not carried at fair value	1,070,446	1,073,278	2,832
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	15,370	15,370	-
Deposits	484,569	484,569	-
Borrowings	425,601	434,447	(8,846)
Other financial liabilities	56,313	56,313	-
Financial liabilities not carried at fair value	981,853	990,699	(8,846)

31.12.2017			
Financial assets not carried at fair value			
Cash and balances with Central Bank	139,819	139,819	-
Loans to credit institutions	86,609	86,609	-
Loans to customers	765,101	772,185	7,084
Other financial assets	8,948	8,948	-
Financial assets not carried at fair value	1,000,477	1,007,561	7,084
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	7,370	7,370	-
Deposits	462,161	462,161	-
Borrowings	384,998	402,355	(17,357)
Other financial liabilities	34,705	34,705	-
Financial liabilities not carried at fair value	889,234	906,591	(17,357)

Loans to customers are largely with variable interest rate. Those loans, including corporate loans, are presented at book value as they have generally short duration and very limited interest rate risk. Loans with fixed interest rate, mainly long term retail mortgages are estimated by using the discount cash flow method with the interest rates offered on new loans, taking into account loan to value. Defaulted loans are presented at book value as no future cash flow is expected on them. Instead they are written down according to their estimated potential recovery value.

The fair value for deposits with stated maturities is calculated by discounting estimated cash flows using current market rates for similar maturities. For deposits that can be withdrawn immediately, the fair value is the amount payable on demand, which is equal to the carrying amount in the Statement of Financial Position.

Amounts are in ISK millions

23. Fair value hierarchy, continued

Derivatives	Notional value	Fair value	
30.9.2018		Assets	Liabilities
Forward exchange rate agreements	68,999	543	719
Fair value hedge of interest rate swap	141,570	999	-
Interest rate and exchange rate agreements	148,531	3,292	1,422
Bond swap agreements	8,075	36	15
Share swap agreements	9,402	1,482	190
Options - purchased agreements	21	1	12
Derivatives	376,598	6,353	2,358
31.12.2017			
Forward exchange rate agreements	52,914	563	251
Fair value hedge of interest rate swap	99,613	80	345
Interest rate and exchange rate agreements	199,723	6,265	1,392
Bond swap agreements	1,818	1	15
Share swap agreements	8,270	701	64
Options - purchased agreements	1,219	14	-
Derivatives	363,557	7,624	2,067

The Group applies fair value hedge accounting only with respect to interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate bonds, see Note 31, arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. On 1 January 2018 the Group implemented IFRS 9, but has elected to continue to apply the hedge accounting principles under IAS 39. For further information about the Group's hedge, accounting policy, see Note 54 in the Annual Financial Statement 2017.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

24. Offsetting financial assets and financial liabilities

Financial assets subject to enforceable master netting arrangements and similar arrangements

	Assets subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
30.9.2018	Gross assets before nettings	Nettings with gross liabilities	Assets recognized on Balance Sheet, net	Financial liabilities	Collateral received	Assets after consideration of netting potential	Assets not subject to enforceable netting arr- angements	Total assets recognized on Balance Sheet, net
Reverse repurchase agreements	12,958	-	12,958	(11,097)	-	1,861	-	12,958
Derivatives	4,503	-	4,503	(936)	-	3,567	1,850	6,353
Total assets	17,461	-	17,461	(12,033)	-	5,428	1,850	19,311
31.12.2017								
Reverse repurchase agreements	15,197	-	15,197	(82)	-	15,115	-	15,197
Derivatives	6,350	-	6,350	(1,210)	-	5,140	1,274	7,624
Total assets	21,547	-	21,547	(1,292)	-	20,255	1,274	22,821

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
30.9.2018	Gross liabilities before nettings	Nettings with gross assets	Liabilities recognized on Balance Sheet, net	Financial assets	Collateral pledged	Liabilities after consideration of netting potential	Liabilities not subject to enforceable netting arr- angements	Total liabilities recognized on balance sheet
Repurchase agreements	11,097	-	11,097	(11,097)	-	-	-	11,097
Derivatives	1,054	-	1,054	(936)	-	118	1,304	2,358
Total liabilities	12,151	-	12,151	(12,033)	-	118	1,304	13,455
31.12.2017								
Repurchase agreements	82	-	82	(82)	-	-	-	82
Derivatives	1,299	-	1,299	(1,210)	-	89	768	2,067
Total liabilities	1,381	-	1,381	(1,292)	-	89	768	2,149

Reverse repurchase agreements and repurchase agreements are recognized within the line items Financial instruments and Due to credit institutions and Central Bank respectively.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

25. Investments in associates

The Group's interest in its principal associates	30.9.2018	31.12.2017
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
Farice ehf., Smáratorg 3, Kópavogur, Iceland	35.8%	35.8%
JCC ehf., Borgartúni 19, Reykjavík, Iceland	33.3%	-
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	23.0%	23.0%
220 Fjördur ehf., Fjardargötu 13-15, Hafnarfjördur, Iceland	37.4%	35.3%

Investments in associates		
Carrying amount at the beginning of the year	760	839
Acquisitions	85	961
Dividend received	-	(41)
Disposals	-	(74)
Share of profit (loss) of associates and net impairment	18	(925)
Investment in associates	862	760

Arion Bank holds 38.4% of share capital in Farice ehf., but holds 35.8% of voting rights, based on different classes of share capital of Farice ehf.

The entity JCC ehf. was founded by the three largest Icelandic banks, with the purpose of operating cash centre in Iceland. Arion Bank's shareholding in JCC ehf. is 33.3%.

26. Intangible assets

Intangible assets comprise following categories; Goodwill, which arises on business combinations; Infrastructure, Customer relationships and related agreements which are identified during the acquisition of subsidiaries and related to the activities of the businesses being acquired; and Software, which is either acquired (i.e. software licenses) or internally developed.

Infrastructure, which is capitalized as an intangible asset, is related to the asset management operation, payment solution and credit card operation and branding of the insurance operation. The business activity is based on years of building up expertise and systems, during which a valuable platform has been created for future growth. An impairment test is performed annually as described below.

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries and agreements bought. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The business activities in question are mainly the business relationship related to individual customers through Retail Banking. The customer relationships is tested for impairment and related agreements are amortized over a period of five years with one year remaining. When deciding on the lifetime of those agreements it was based on experience of the Bank and the industry. As a result, those agreements are assessed as having an identified useful lifetime.

Acquired software and internally developed software is capitalized on the basis of the cost of acquiring them and bringing them into service. Computer software licenses recognized as intangible assets are amortized over their useful life, which is estimated to be 3-10 years.

Policies applied to the Group's intangible assets	Goodwill and infrastructure	Customer relationship and related agreements	Software
Useful lives	Undefined	Finite 5-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 5-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Internally generated and acquired

Amounts are in ISK millions

26. Intangible assets, continued

30.9.2018	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	4,315	3,705	1,492	4,336	13,848
Additions and transfers	-	-	-	986	986
Additions, internally developed	-	-	-	470	470
Transfers and recalculation	(414)	-	106	14	(294)
Exchange difference	90	-	14	39	143
Amortization	-	-	(257)	(857)	(1,114)
Intangible assets	3,991	3,705	1,355	4,988	14,039

31.12.2017	Goodwill	Infra-structure	Customer relation-ship and related agreements	Software	Total
Balance at the beginning of the year	2,202	3,705	1,608	3,542	11,057
Acquisition through business combination	1,773	-	297	107	2,177
Additions and transfers	174	-	(125)	1,310	1,359
Additions, internally developed	-	-	-	347	347
Exchange difference	166	-	20	41	227
Impairment	-	-	(3)	-	(3)
Amortization	-	-	(305)	(1,011)	(1,316)
Intangible assets	4,315	3,705	1,492	4,336	13,848

Goodwill is recognized in the segment Subsidiaries and other divisions, see Note 4.

27. Tax assets and tax liabilities

	30.9.2018		31.12.2017	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	5,618	-	6,329
Deferred tax	623	758	450	499
Tax assets and tax liabilities	623	6,376	450	6,828

28. Non-current assets and disposal groups held for sale

	30.9.2018	31.12.2017
Disposal groups held for sale	6,406	5,219
Real estate	1,883	2,879
Other assets	62	40
Non-current assets and disposal groups held for sale	8,351	8,138

Real estates and other assets classified as non-current assets held for sale are generally the result of foreclosures on companies and individuals.

Stakksberg ehf. a subsidiary of Eignabjarg ehf.

On 22 January 2018 United Silicon was declared bankrupt following serious operational problems which resulted it its operating license being temporarily suspended, as well as a failed attempt at reaching a composition with its creditors. In February 2018 an agreement was reached between the administrator of the bankrupt estate of United Silicon and Arion Bank, whereby the Bank foreclosed against its collateral and acquired all the company's main assets. Disputes with other creditors regarding the validity of the collateral and assurances provided by the Bank in relation thereto are disclosed in Note 35. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through a newly established subsidiary, Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, successfully worked to reduce uncertainties surrounding the recommissioning of the silicon plant, amongst other things by securing all necessary operating permits, power supply and undertaking further engineering design groundwork necessary for the carrying out of remedial work prior to the reopening of the plant. The Bank's objective is to divest Stakksberg ehf. during the fourth quarter of 2018 on the basis of the preparatory work already undertaken. Consequently the Stakksberg ehf. shares are currently classified as disposal group held for sale as of 30 September 2018 in accordance with IFRS 5.

Amounts are in ISK millions

29. Other assets

	30.9.2018	31.12.2017
Property and equipment	6,407	6,561
Accounts receivable	5,915	6,531
Unsettled securities trading	19,393	481
Investment for life assurance policyholders where risk is held by policyholder	903	869
Sundry assets	3,682	2,524
Other assets	36,300	16,966

30. Other liabilities

Accounts payable	25,790	26,394
Unsettled securities trading	19,583	527
Depositors' and Investors' Guarantee Fund	216	218
Technical provision	13,696	12,129
Technical provision for life assurance policyholders were investment risk is held by policyholder	903	869
Withholding tax	1,988	1,414
Bank levy	5,792	3,172
Sundry liabilities	16,208	12,339
Other liabilities	84,176	57,062

Technical provision	Technical provision	Reinsurers' share	Total 30.9.2018	Technical provision	Reinsurers' share	Total 31.12.2017
Claims reported and loss adjustment expenses	6,810	(96)	6,714	5,587	(121)	5,466
Claims incurred but not reported	1,083	(113)	970	1,664	(99)	1,565
Claims outstanding	7,893	(209)	7,684	7,251	(220)	7,031
Provision for unearned premiums	5,803	(19)	5,784	4,878	(19)	4,859
Own technical provision	13,696	(228)	13,468	12,129	(239)	11,890

Insurance claim consists of claims outstanding and provision for unearned premiums. Claims outstanding present unsettled claims incurred. Claims outstanding is the total of claims reported and actuarial estimation of claims incurred but not reported. Provision for unearned premiums presents the current insurance risk that will be conditional on future fiscal years.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

31. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	30.9.2018	31.12.2017
ARION CBI 19, ISK 4,500 million	2013	2019	At maturity	Fixed, CPI linked, 2.50%	4,663	4,586
ARION CB 19, ISK 2,740 million	2016	2019	At maturity	Fixed, 5.50%	1,811	1,789
ARION CBI 21, ISK 10,220 million ...	2014	2021	At maturity	Fixed, CPI linked, 3.50%	9,941	9,729
ARION CB 22, ISK 27,940 million	2015	2022	At maturity	Fixed, 6.50%	27,283	23,339
ARION CBI 25, ISK 32,840 million ...	2017	2025	At maturity	Fixed, CPI linked, 3.00%	33,777	22,875
ARION CBI 29, ISK 25,220 million ...	2014	2029	At maturity	Fixed, CPI linked, 3.50%	26,994	26,243
ARION CBI 34, ISK 2,500 million	2012	2034	Amortizing	Fixed, CPI linked, 3.60%	-	2,152
ARION CBI 48 ISK 6,760 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	5,609	-
Statutory covered bonds					110,078	90,713
ARION CB 2, ISK 51,125 million	2006	2048	Amortizing	Fixed, CPI linked, 3.75%	78,929	78,267
Structured Covered bonds					78,929	78,267
Total Covered bonds					189,007	168,980
EUR 21 million	2009	2018	Amortizing	Floating, EURIBOR +1.00%	188	348
ISK 3,835 million	2010	2018	Amortizing	Floating, REIBOR +1.00%	275	531
EUR 300 million	2015	2018	At maturity	Fixed, 3.125%	-	25,461
SEK 500 million	2016	2018	At maturity	Floating, 3 month STIBOR +1.09%	6,248	6,348
EUR 300 million	2016	2019	At maturity	Fixed, 2.50%	39,011	37,957
RON 35 million	2016	2019	At maturity	Fixed, 3.80%	993	966
SEK 275 million	2016	2019	At maturity	Floating, 3 month STIBOR +2.65%	3,434	3,485
SEK 100 million	2017	2019	At maturity	Fixed, 0.29%	1,248	1,268
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	11,001	10,236
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	4,389	4,087
EUR 300 million*	2017	2020	At maturity	Fixed, 0.75%	38,535	37,356
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	3,755	3,811
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	3,124	3,173
EUR 500 million*	2016	2021	At maturity	Fixed, 1.625%	64,063	61,341
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,447	3,231
EUR 300 million*	2018	2023	At maturity	Fixed, 1.00%	38,548	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,452	3,240
Senior unsecured bonds					221,711	202,839
Bills issued					14,676	10,794
Other					207	2,385
Other loans/bills					14,883	13,179
Borrowings					425,601	384,998

*The Group applies fair value hedge accounting to these bond issuances and uses certain foreign currency denominated interest rate swaps as hedging instruments, see Note 23. The interest rate swaps are hedging the exposure of the Group's changes in the fair value of these fixed-rate foreign currency denominated bonds arising from changes in interest rates. The Group started to apply hedge accounting at the beginning of 2017. The total carrying amount of the bond issuances is ISK 141,146 million and included in the amount are positive fair value changes amounting to ISK 202 million, see Note 8.

The book value of listed bonds was ISK 410 billion at the end of the period (31.12.2017: ISK 371 billion). The market value of those bonds was ISK 419 billion (31.12.2017: ISK 388 billion). The Group repurchased own debts during the period for the amount of ISK 1 billion (2017: ISK 20 billion) with minor effects on the Consolidated Interim Income Statement.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

32. Pledged assets

Pledged assets against liabilities	30.9.2018	31.12.2017
Assets, pledged as collateral against borrowings	224,513	202,381
Assets, pledged as collateral against loans from credit institutions and short positions	5,748	13,364
Pledged assets against liabilities	230,261	215,745

The Group has pledged assets against borrowings, both issued covered bonds and other issued bonds and loan agreements. The total value of those pledged assets was ISK 225 billion at the end of the period (31.12.2017: ISK 202 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 189 billion at the end of the period (31.12.2017: ISK 169 billion).

The Group has pledged bonds against short term lending from the Central Bank of Iceland and against short positions, related to swap agreements, to hedge market risk of those assets.

33. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 2,000 million, with par value of ISK 1 per share. The holders of ordinary shares are entitled to receive dividends as approved by the general meeting and are entitled to one vote per share at Shareholders' meetings.

	Number (million)	30.9.2018	Number (million)	31.12.2017
Issued share capital	2,000	75,861	2,000	75,861
Purchase of treasury stock	(186)	(16,847)	-	-
Shares outstanding	1,814	59,014	2,000	75,861
Own shares	186	16,661	-	-

Share premium represents excess of payment above nominal value that shareholders have paid for shares issued by Arion Bank hf.

Other reserves	30.9.2018	31.12.2017
Statutory reserve	1,637	1,637
Reserve for investments in subsidiaries	12,843	14,011
Reserve for investments in associates	56	39
Reserve for investments in securities	564	901
Reserve for financial instruments carried at fair value through OCI, net of tax	152	-
Foreign currency translation reserve	396	186
Other reserves	15,648	16,774

Notes to the Condensed Consolidated Interim Financial Statements

Other information

34. Shareholders of Arion Bank

Shareholders of Arion Bank hf. with shareholding exceeding 1% of the Bank's issued share capital

	30.9.2018	31.12.2017
Kaupskil ehf. (subsidiary of Kaupthing hf.)	32.67%	57.41%
Taconic Capital (through TCA New Sidecar s.á.r.l.)	9.99%	9.99%
Arion banki hf.	9.31%	-
Attestor Capital	8.58%	10.44%
Och Ziff Capital management	6.58%	6.58%
Goldman Sachs funds	3.37%	2.57%
Lansdowne funds	2.95%	-
Eaton Vance funds	1.78%	-
Miton Asset Management funds	1.37%	-
Gildi pension fund	1.27%	-
Icelandic State Financial Investments	-	13.00%
Other	22.13%	-
Issued share capital	100.00%	100.00%

35. Legal matters

The Group has in place formal controls and policies for managing legal claims. Once professional advice has been obtained and the likelihood and amount of loss reasonably estimated, the Group makes adjustments, if appropriate, to account for any adverse effects the claims may have on its financial standing. Should the Group conclude that it is to the detriment of the Group's case to disclose such potential amounts, relating to the legal claims raised, it elects not to do so. At the end of the period, the Group had several unresolved legal claims.

Contingent liabilities

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., has filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintain that the Bank caused them, as shareholders of BM Vallá hf. and Fasteignafélagid Ártún ehf., damage by not allowing the companies to be financially restructured and thereby forcing the companies into bankruptcy. In April 2018 the District Court of Reykjavík dismissed one of the cases ex officio. The plaintiffs appealed the judgment to the Court of Appeal. In June 2018 the Court of Appeal annulled the judgment of the District Court and ordered the District Court to hear the case again. The District Court acquitted the Bank of all claims with a judgment in September.The plaintiffs have appealed the judgment to the Court of Appeal. The second case awaits the result of this case. The Bank believes that it will be acquitted of the plaintiffs' claims in both cases and has therefore not made any provision.

In January 2015, Datacell ehf. and Sunshine Press Productions ehf. jointly filed a suit against Valitor hf. for compensatory damages amounting to approximately ISK 8.1 billion relating to Valitor hf.'s termination of Datacell's vendor agreement. The Icelandic Supreme Court ruled on 24 April 2013 in case no. 612/2012 that Valitor hf. did not have the authority to terminate the agreement. The plaintiffs had court-appointed appraisers evaluate the plaintiffs' alleged losses and they returned their report in March 2016. Valitor hf. disagreed with the assessment stated in the report and filed a motion to appoint three court appraisers to re-evaluate the plaintiffs' alleged losses. The District Court agreed to Valitor hf.'s demand. The reassessment has been completed but it was not filed with the court. Valitor hf. requested a new assessment, which would examine particular aspects which have not yet been assessed. The District Court and the Court of Appeal have rejected the request. In February 2018 Datacell and Sunshine Press Production applied for the freezing of Valitor's assets on the basis of the aforementioned claim of compensatory damages but the district magistrate declined the application. The plaintiffs subsequently filed a complaint with the District Court to re-evaluate the decision by the Magistrate to decline the freezing of assets. The District Court of Reykjavík confirmed the magistrate's decision with a judgment on 7 June 2018. Datacell and Sunshine Press Production again applied for the freezing of Valitor's assets which the district magistrate again rejected on 6 July 2018. Datacell and Sunshine Press Productions have appealed the decision to the District Court. There will be a hearing regarding Valitor's dismissal claim on the freezing request on 12 November 2018. The District Court has also fixed a time for a trial regarding the damages claim on 12 December 2018. When Arion Bank acquired a 38,62% shareholding in Valitor Holding hf. in 2014-2015, the Bank signed agreements with the seller (Landsbankinn) concerning losses which Valitor may potentially sustain in relation to the compensatory damages described above. Thus the Group may lodge a claim against the seller for their share in the potential loss should Valitor lose the case. The Group has not made any provision in this case.

Amounts are in ISK millions

35. Legal matters, continued

Other legal matters

Mortgage documents

Cases have been lodged against the Bank, where claims are made for the invalidation of mortgaging of parts of a property. The claims are made on the basis that the signatures of the mortgagor on the respective mortgage documents were incorrect. In 2017, the Supreme Court ruled on the issue in several cases which did not involve the Bank. In the majority of those cases, the Supreme Court invalidated the disputed mortgage. At the district court level, several court cases involving the Bank regarding the aforementioned issue have been ruled upon. In the majority of those, the district court invalidated the disputed mortgage. The overall legal situation has become clearer and the Bank is assessing how to treat those loan documents to which the above precedent may apply.

United Silicon

The company United Silicon was granted a moratorium on payments on 14 August 2017 and filed for bankruptcy on 22 January 2018. The Bank had collateral in the company's assets and the estate has transferred the assets to the Bank. The trustee in the estate has approved the Bank's claims but two unsecured creditors have lodged a protest against the Bank's lien on the assets of United Silicon. The trustee in the bankruptcy has referred the disagreement to the District Court of Reykjanes. The Bank has examined these protests and rejects them all. It should be noted that in the agreement between the Bank and the estate, it is stated that should the Bank's collateral be judicially deemed to be invalid, the Bank will refund the estate the amount of the invalidated bond.

Penalty interest during extension of payments

The Supreme Court ruled on 8 March 2018, in case no. 159/2017, that the Bank was not permitted to calculate penalty interest on a customer's debt during the period in which the said customer had been granted an extension of payments under the law on debt mitigation. Since the judgment was handed out the Bank has examined how many customers have paid penalty interest on their debts to the Bank during this extension period. The Bank is in the process of correcting loans of those customers, either with repayment or debt reduction. The final impact is not clear but all indications suggest that the financial impact will be minimal.

Legal matters concluded

Housing association Húsfélagid Löngulínu 2

In 2016 the housing association Húsfélagid Löngulínu 2 filed a suit against the Bank for the payment of compensation due to defects in the property at Langalína 2. The Bank had provided credit to the company, which began constructing the property, and later became a shareholder when the Bank took over the company due to its difficulties in repaying the loan. The Bank based its case, among other things, on the notion that it could not be held liable for defects to the property as a lender and/or shareholder. In September 2018 the Bank was ordered by the Supreme Court to pay the housing association compensation amounting to ISK 161 million, plus penalty interest and costs.

38. Events after the reporting period

In October 2018 the Bank sold its 30% shareholding in EAB 1 ehf. to other shareholders of the entity. The transaction will have no effect on the Statement of Comprehensive Income in the fourth quarter 2018.

Notes to the Condensed Consolidated Interim Financial Statements

Off balance sheet information

36. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers

	30.9.2018	31.12.2017
Financial guarantees	15,916	13,224
Unused overdrafts	45,276	45,897
Undrawn loan commitments	91,698	87,942
Financial guarantees, unused credit facilities and undrawn loan commitments the Group has granted its customers	152,890	147,063

Depositors' and Investors' Guarantee Fund

The Icelandic parliament has discussed a bill on a new Depositors' and Investors' Guarantee Fund, without reaching a conclusion on the matter.

37. Assets under management and under custody

	30.9.2018	31.12.2017
Assets under management	950,971	984,653
Assets under custody	1,418,060	1,620,355

Assets under management represent the total market value of the financial assets which the Group manages on behalf of its customers.

The Group, acting as custodian, is responsible for safeguarding a firm's or individual's financial assets, hold in safekeeping securities such as stocks, bonds and securities funds, arrange the settlement of trades and movements of securities, process corporate actions such as income on bonds and dividends on shares; and pricing on securities.

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Related party

39. Related party

The Group has a related party relationship with entities with influence over the Group as the largest shareholders of Arion Bank, which are on 30 September 2018 Kaupskil ehf. (32.67%) and Taconic Capital (9.99%), the Board of Directors of Kaupskil ehf. and Kaupthing hf., being the parent company of Kaupskil ehf. and entities controlled by them.

The Board of Directors of Arion Bank, key management personnel of the Bank and the Group's associates are defined as related parties, as are close family members of the individuals referred to above and legal entities controlled by them.

At year end 2017 Kaupskil ehf. (57.41%) was defined as shareholder with control over the Group, the Board of Directors of Kaupskil ehf. and Kaupthing hf.as well as Taconic Capital Advisors UK LLP (9.99%) and Och Ziff Capital management (6.58%) as their shareholdings were managed by Kaupskil ehf. At year end 2017 Attestor Capital LLP (10.44%), Goldman Sachs International (2.57%) and the Icelandic State Financial Investments (13.00%) were defined as related parties with influence over the Group.

Transactions with related parties have been conducted on an arm's length basis. There have been no further guarantees provided or received for related party receivables or payables.

Balances with related parties

30.9.2018	Assets	Liabilities	Net balance
Shareholders with influence over the Group	31	(3,639)	(3,608)
Board of Directors and key Management personnel	161	(550)	(389)
Associates and other related parties	-	(9)	(9)
Balances with related parties	192	(4,198)	(4,006)

31.12.2017			
Shareholders with control over the Group	57	(4,785)	(4,728)
Shareholders with influence over the Group	423	(151)	272
Board of Directors and key Management personnel	183	(101)	82
Associates and other related parties	-	(83)	(83)
Balances with related parties	663	(5,121)	(4,457)

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Risk management disclosures

The Group faces various risks arising from its day to day operations. Managing risk is therefore a core activity within the Group. The key to effective risk management is a process of on-going identification of significant risk, quantification of risk exposure, actions to limit risk and constant monitoring of risk. This process of risk management and the ability to evaluate, manage and correctly price the risk encountered is critical to the Group's continuing profitability as well as to be able to ensure that the Group's exposure to risk remains within acceptable levels.

Further information regarding risk management is available in the Annual Financial Statements and in the Pillar 3 Risk Disclosures, published on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not audited.

40. Credit risk

Credit risk is the risk that the Group will incur a loss because its customers or counterparties fail to discharge their contractual obligations.

Credit risk arises anytime the Group commits its funds, resulting in capital or earnings being dependent on counterparty, issuer or borrower performance. Loans to customers and credit institutions are the largest source of credit risk. Credit risk is also inherent in other types of assets, such as bonds and debt instruments, and off balance sheet items such as commitments and guarantees.

Managing and analyzing the Group's loan portfolio is of utmost importance. Great emphasis is placed on the quality of the credit portfolio, by maintaining a strict credit process, critically inspecting loan applications, actively monitoring the credit portfolio and identifying and reacting to possible problem loans at an early stage as well as restructuring of impaired credits.

The Group grants credit based on well informed lending decisions and seeks business with strong parties with strong collaterals and good repayment capacity. The risk level of each credit is considered in the pricing.

Credit risk is managed and controlled by setting limits on the amount of risk the Group is willing to accept for individual counterparties and group of connected clients, and by monitoring exposures in relation to such limits. The Group seeks to limit its total credit risk through diversification of the loan portfolio across sectors and by limiting large exposures to group of connected clients.

Exposure to credit risk

The table below shows the maximum exposure to credit risk for the components of the Interim Statement of Financial Position before the effect of mitigation due to collateral agreements or other credit enhancements. The table also shows related collateral and credit enhancements. The amount and type of collateral required depends on an assessment of the credit risk of the counterparty and the exposure type. The main types of collateral obtained are as follows:

- Retail loans to individuals: Mortgages on residential properties.
- Corporate loans: Real estate, fishing vessels and other fixed and current assets, including inventory and trade receivables, cash and securities.
- Derivative exposures: Cash, treasury notes and bills, asset backed bonds, listed equity and funds that consist of eligible securities.

The value of collateral is based on estimated market value. The valuation of real estate is built on market price, official valuation of the Icelandic Property Registry, or the opinion of internal or external specialists. The valuation of fishing vessels takes into account related fishing quotas.

Collateral value is monitored and additional collateral requested in accordance with the underlying agreement. Collateral value is reviewed in line with the adequacy of the allowance for impairment losses. Collateral value are capped by the exposure amount. Comparative figures have not been updated.

40. Credit risk, continued

Maximum exposure to credit risk and collateral held against different types of financial instruments subject to the impairment requirements of IFRS 9

30.9.2018	Maximum exposure	Collateral: Cash and securities	Real estate	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	99,525	-	-	-	-	-
Loans to credit institutions	123,446	-	-	-	-	-
Loans to customers at amortized cost	813,621	16,436	567,933	62,969	73,204	720,542
Individuals	*397,661*	*874*	*357,009*	*20*	*10,848*	*368,751*
Corporates	*415,960*	*15,562*	*210,924*	*62,949*	*62,356*	*351,791*
Real estate activities and construction	*134,998*	*587*	*122,050*	*16*	*2,215*	*124,868*
Fishing industry	*81,947*	*11*	*9,024*	*61,804*	*8,632*	*79,471*
Information and communication technology	*23,069*	*474*	*3,411*	-	*8,832*	*12,717*
Wholesale and retail trade	*64,870*	*316*	*33,030*	*11*	*24,562*	*57,919*
Financial and insurance activities	*30,103*	*14,061*	*5,681*	*683*	*6,347*	*26,772*
Industry, energy and manufacturing	*32,881*	*57*	*20,957*	*49*	*6,371*	*27,434*
Transportation	*17,484*	*4*	*1,037*	*286*	*2,065*	*3,392*
Services	*17,589*	*39*	*7,141*	*100*	*2,878*	*10,158*
Public sector	*5,676*	*9*	*1,923*	-	*180*	*2,112*
Agriculture and forestry	*7,343*	*4*	*6,670*	-	*274*	*6,948*
Other assets with credit risk	27,510	6,965	-	-	-	6,965
Financial guarantees	15,916	1,564	4,173	1,715	3,844	11,296
Undrawn loan commitments and unused overdrafts	136,974	-	-	-	-	-
Fair value through OCI	48,718	-	-	-	-	-
Government bonds	*39,195*	-	-	-	-	-
Corporate bonds	*9,523*	-	-	-	-	-
Balance at the end of the period	1,265,710	24,965	572,106	64,684	77,048	738,803

Maximum exposure to credit risk and collateral held against different types of financial instruments under IAS 39

31.12.2017	Maximum exposure	Collateral: Cash and securities	Real estates	Fishing vessels	Other collateral	Total collateral
Cash and balances with Central Bank	139,819	-	-	-	-	-
Loans to credit institutions	86,609	-	-	-	-	-
Loans to customers	765,101	15,571	525,401	53,986	55,790	650,748
Individuals	*365,287*	*195*	*326,456*	*16*	*8,413*	*335,080*
Corporates	*399,814*	*15,376*	*198,945*	*53,970*	*47,377*	*315,668*
Real estate activities and construction	*128,153*	*371*	*115,467*	*208*	*1,928*	*117,974*
Fishing industry	*78,937*	*24*	*8,569*	*52,693*	*10,580*	*71,866*
Information and communication technology	*22,020*	*541*	*1,103*	-	*2,035*	*3,679*
Wholesale and retail trade	*57,432*	*208*	*32,294*	*12*	*16,131*	*48,645*
Financial and insurance activities	*34,138*	*13,440*	*4,184*	*681*	*6,174*	*24,479*
Industry, energy and manufacturing	*29,452*	*660*	*19,367*	-	*5,747*	*25,774*
Transportation	*17,111*	*3*	*973*	*278*	*1,395*	*2,649*
Services	*18,157*	*15*	*7,365*	*98*	*3,047*	*10,525*
Public sector	*7,824*	*114*	*3,657*	-	*92*	*3,863*
Agriculture and forestry	*6,590*	-	*5,966*	-	*248*	*6,214*
Financial instruments	78,784	5,948	-	-	-	5,948
Other assets with credit risk	8,948	-	-	-	-	-
Financial guarantees	13,224	871	3,343	1,598	3,343	9,155
Undrawn loan commitments and unused overdrafts	133,839					-
Balance at the end of the period	1,226,324	22,390	528,744	55,584	59,133	665,851

Amounts are in ISK millions

40. Credit risk, continued

LTV ratio for residential mortgage lending

The following table describes the loan to value (LTV) and impairment status of the Group's mortgage loan book. LTV is calculated as the ratio of the gross amount of the loan to the value of the collateral without adjusting for possible costs of obtaining and selling the collateral. The collateral value is based on the value at origination, the most recent appraisals or official property valuation from the Icelandic Property Registry. For credit impaired loans the value of collateral is based on the most recent appraisals.

30.9.2018	Gross carrying amount	Thereof credit impaired
Less than 50%	118,014	951
50-70%	122,521	1,978
70-90%	74,034	1,536
90-100%	19,849	513
100%-110%	11,120	486
More than 110%	15,079	935
Not classified	40	-
Balance at the end of the period	360,657	6,399

At the end of the period the gross carrying amount of assets in stage 3 are ISK 18,686 million with ISK 12,592 million in collateral, there of ISK 11,131 million in real estate.

Collateral repossessed

During the period the Group took possession of assets due to foreclosures. The total amounts of real estates the Group took possession of during the period and still holds at the end of the period amount to ISK 488 million (31.12.2017: ISK 833 million) and other assets ISK 30 million (31.12.2017: ISK 2 million). The assets are held for sale, see Note 29.

Credit quality

The Bank uses internal credit rating models and external credit ratings if available to monitor credit risk. The internal credit rating models rate customers with one of four statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Two models rate individuals' exposures – one for prime mortgages and another for other exposures. The models are updated at least annually and recalibrated with current data with the aim of improving their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement. External ratings are used for marketable securities, cash and balances, and loans to credit institutions. For further information on the rating scales used, see Note 45.

The tables below show financial instruments subject to the impairment requirements of IFRS 9 broken down by rating scale, where risk class 5, DD denotes, the highest risk. Assets carried at fair value through profit and loss are not subject to the impairment requirements of IFRS 9. The tables below sum up the gross carrying amount of assets by rating class and current impairment stage. The gross carrying amount net of loss allowance shows the book value of the underlying assets.

Exposures that are 'Unrated' are typically due to newly formed entities, entities for which the Bank's rating models are not applicable or no external rating is available. Comparative figures have not been restated.

Amounts are in ISK millions

40. Credit risk, continued

Credit quality profile by rating class

30.9.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Assets carrying stage 1 ECL			
Investment grade	99,527	120,490	48,725
Non-investment grade	-	389	-
Unrated	-	2,605	-
Gross carrying amount	99,527	123,484	48,725
Loss allowance	(2)	(38)	(7)
Book value	99,525	123,446	48,718

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	353,141	71	-	-	353,212
Risk class 2 - (Grades BB+ to BB-)	260,303	17,692	-	-	277,995
Risk class 3 - (Grades B+ to B-)	116,082	21,888	-	65	138,035
Risk class 4 - (Grades CCC+ to CCC-)	15,962	12,052	-	111	28,125
Risk class 5 - (DD)	-	-	18,685	5,507	24,192
Unrated	3,477	503	163	-	4,143
Gross carrying amount	748,965	52,206	18,848	5,683	825,702
Loss allowance	(1,348)	(839)	(6,476)	(3,418)	(12,081)
Book value	747,617	51,367	12,372	2,265	813,621

Loans to customers - mortgage loans	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 1 - (Grades A+ to BBB-)	186,963	15	-	-	186,978
Risk class 2 - (Grades BB+ to BB-)	110,401	4,404	-	-	114,805
Risk class 3 - (Grades B+ to B-)	33,683	4,054	-	65	37,802
Risk class 4 - (Grades CCC+ to CCC-)	8,196	6,273	-	101	14,570
Risk class 5 - (DD)	-	-	5,778	621	6,399
Unrated	95	8	-	-	103
Gross carrying amount	339,338	14,754	5,778	787	360,657
Loss allowance	(147)	(86)	(400)	(64)	(697)
Book value	339,191	14,668	5,378	723	359,960

Loan commitments, guarantees and unused credit facilities	Stage 1	Stage 2	Stage 3	Total
Risk class 1 - (Grades A+ to BBB-)	90,046	6	-	90,052
Risk class 2 to 4 - (Grades BB+ to CCC-)	52,367	6,511	3,223	62,101
Unrated	522	215	-	737
Gross carrying amount	142,935	6,732	3,223	152,890
Loss Allowance	(181)	(191)	(1,710)	(2,082)
Book value	142,754	6,541	1,513	150,808

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

31.12.2017 *Credit quality by class of financial assets*	Neither past due nor impaired	Past due but not impaired	Individu-ally impaired	Total
Cash and balances with Central Bank	139,819	-	-	139,819
Loans to credit institutions	86,609	-	-	86,609
Loans to customers				
Loans to corporates	385,197	13,655	962	399,814
Loans to individuals	344,829	18,929	1,529	365,287
Financial instruments	78,784	-	-	78,784
Other assets with credit risk	8,948	-	-	8,948
Credit quality by class of financial assets	1,044,186	32,584	2,491	1,079,261

The following table shows loans to customers that are neither past due nor impaired, broken down by the Bank's classification scale as under IAS 39, where 5 denotes the highest risk. The disclosure has not been restated after the implementation of IFRS 9.

Neither past due nor impaired loans	Risk classification						
	1	2	3	4	5	Unrated	Total
Individuals	176,980	116,296	36,507	9,953	2,238	2,855	344,829
Real estate activities and construction	28,508	51,363	40,327	3,013	83	479	123,773
Fishing industry	37,742	28,908	9,129	1,498	653	-	77,930
Information and communication technology	17,691	1,162	2,958	21	-	3	21,835
Wholesale and retail trade	19,996	20,822	9,368	2,117	563	141	53,007
Financial and insurance activities	14,638	3,708	15,103	105	-	10	33,564
Industry, energy and manufacturing	17,236	6,394	4,233	794	187	-	28,844
Transportation	10,644	3,713	2,201	48	-	65	16,671
Services	2,392	6,227	5,224	432	2,443	3	16,721
Public sector	1,730	4,938	862	108	47	-	7,685
Agriculture and forestry	863	1,740	1,816	585	163	-	5,167
Neither past due nor impaired loans	328,420	245,271	127,728	18,674	6,377	3,556	730,026

Past due but not impaired loans by class of loans	Up to 3 days	4 to 30 days	31 to 60 days	61 to 90 days	More than 90 days	Total
Loans to corporates	4,361	4,221	1,774	1,339	1,960	13,655
Loans to individuals	3,065	8,149	4,387	350	2,978	18,929
Past due but not impaired loans	7,426	12,370	6,161	1,689	4,938	32,584

Loans past due up to three days are mainly overdrafts that were not renewed in time. The majority of the past due but not impaired loans are considered fully secured with collateral or have been acquired at discount. Loans acquired at discount are not considered to be impaired unless the specific allowance exceeds the discount received.

	31.12.2017	
Impaired loans to customers specified by sector	Impair-ment amount	Gross carrying amount
Individuals	4,010	5,539
Real estate activities and construction	467	762
Fishing industry	658	861
Information and communication technology	111	112
Wholesale and retail trade	490	702
Financial and insurance activities	297	314
Industry, energy and manufacturing	473	581
Transportation	1	1
Services	3,570	3,617
Public sector	45	45
Agriculture and forestry	165	244
Impaired loans to customers specified by sector	10,287	12,778

Amounts are in ISK millions

40. Credit risk, continued

The following tables reconciles the opening and closing allowance balance for debt securities at amortized cost and FVOCI by their impairment requirements. The reconciliation includes:

• Transfers of financial assets between impairment requirements: include transfers to 12 month expected credit losses, to lifetime expected credit losses and credit impaired financial assets. All transfers are presumed to occur before any corresponding remeasurement of the loss allowance.

• Net remeasurement of loss allowance: comprise the impact of changes in model inputs or assumptions, including changes in forward-looking macroeconomic conditions, partial repayments and additional draws on existing facilities, inflation, changes in the measurement following a transfer between stages, and unwinding of the time value discount due to the passage of time.

• New financial assets: include purchases and originations and reflect the allowance related to assets newly recognized during the period.

• Derecognitions and maturities, reflect the allowance related to assets derecognized during the period without a credit loss being incurred, including those assets that were derecognized following a modification of terms.

• Write-offs: the amount after net remeasurements of loss allowance written off during the period.

• Foreign exchange: the effects of foreign exchange on the loss allowance between periods.

During the first quarter there were no significant changes to the models used to estimate expected credit loss.

Impairment loss allowance total

1.1.-30.9.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,346	-	13,541
Net remeasurement	(1,309)	621	(363)	363	(688)
Opening balance at 1.1.2018	1,886	621	9,983	363	12,853
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	974	(498)	(476)	-	-
Transfers to Stage 2 - (lifetime ECL)	(226)	411	(185)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(145)	(214)	359	-	-
Net remeasurement of loss allowance	(1,189)	819	3,930	868	4,428
New financial assets, originated or purchased	579	60	435	2,247	3,321
Derecognitions and maturities	(291)	(142)	(3,032)	(35)	(3,500)
Write-offs	(22)	(41)	(2,894)	(146)	(3,103)
Foreign exchange difference	10	14	66	121	211
Impairment loss allowance	1,576	1,030	8,186	3,418	14,210

1.7.-30.9.2018	Stage 1	Stage 2	Stage 3	POCI	Total
Opening balance at 1.7.2018	1,593	910	6,533	2,552	11,588
Transfers of financial assets:					
Transfers to Stage 1 - (12-month ECL)	258	(194)	(64)	-	-
Transfers to Stage 2 - (lifetime ECL)	(53)	58	(5)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(49)	(57)	106	-	-
Net remeasurement of loss allowance	(274)	356	2,134	804	3,020
New financial assets, originated or purchased	187	12	252	-	451
Derecognitions and maturities	(92)	(65)	(254)	(8)	(419)
Write-offs	(5)	1	(585)	(32)	(621)
Foreign exchange difference	11	9	69	102	191
Impairment loss allowance	1,576	1,030	8,186	3,418	14,210

Amounts are in ISK millions

40. Credit risk, continued

Impairment loss allowance for assets only carrying 12-month ECL

1.1.-30.9.2018	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI	Total
ECL balance at 31.12.2017	-	-	-	-
Net remeasurement	7	3	3	13
Opening balance at 1.1.2018	7	3	3	13
Net remeasurement of loss allowance	(4)	31	(5)	22
Net effects of trading	(1)	4	9	12
Impairment loss allowance for assets only carrying 12-month ECL	2	38	7	47

1.7.-30.9.2018				
Opening balance at 1.6.2018	2	32	19	53
Net remeasurement of loss allowance	-	3	(13)	(10)
Net effects of trading	-	3	1	4
Impairment loss allowance for assets only carrying 12-month ECL	2	38	7	47

Impairment loss allowance for loans to customers

1.1.-30.9.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	3,195	-	10,288	-	13,483
Net remeasurement	(1,502)	572	(363)	363	(930)
Opening balance at 1.1.2018	1,693	572	9,925	363	12,553
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	908	(462)	(446)	-	-
Transfers to Stage 2 - (lifetime ECL)	(208)	393	(185)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(123)	(211)	334	-	-
Net remeasurement of loss allowance	(1,146)	642	1,967	868	2,331
New financial assets, originated or purchased	403	52	413	2,247	3,115
Derecognitions and maturities	(166)	(116)	(2,684)	(35)	(3,001)
Write-offs	(22)	(41)	(2,894)	(146)	(3,103)
Foreign exchange	9	10	46	121	186
Impairment loss allowance for loans to customers	1,348	839	6,476	3,418	12,081

1.7.-30.9.2018					
Opening balance at 1.4.2018	1,343	803	6,491	2,552	11,189
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	247	(183)	(64)	-	-
Transfers to Stage 2 - (lifetime ECL)	(50)	55	(5)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(28)	(56)	84	-	-
Net remeasurement of loss allowance	(242)	259	510	804	1,331
New financial assets, originated or purchased	122	11	233	-	366
Derecognitions and maturities	(49)	(57)	(254)	(8)	(368)
Write-offs	(6)	(2)	(588)	(32)	(628)
Foreign exchange	11	9	69	102	191
Impairment loss allowance for loans to customers	1,348	839	6,476	3,418	12,081

Amounts are in ISK millions

40. Credit risk, continued

Impairment loss allowance for loans to customers - mortgage loans

1.1.-30.9.2018	Stage 1	Stage 2	Stage 3	POCI	Total
ECL balance at 31.12.2017	538	-	797	-	1,335
Net remeasurement	(345)	70	(128)	127	(276)
Opening balance at 1.1.2018	193	70	669	127	1,059
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	152	(46)	(106)	-	-
Transfers to Stage 2 - (lifetime ECL)	(22)	32	(10)	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(4)	(19)	23	-	-
Net remeasurement of loss allowance	(220)	55	(24)	(48)	(237)
New financial assets, originated or purchased	61	5	-	-	66
Derecognitions and maturities	(9)	(5)	(60)	(10)	(84)
Write-offs	(4)	(6)	(92)	(5)	(107)
Impairment loss allowance for loans to customers - mortgage loans	147	86	400	64	697

1.7.-30.9.2018	Stage 1	Stage 2	Stage 3	POCI	Total
Opening balance at 1.7.2018	160	81	416	70	727
Transfers of financial assets					
Transfers to Stage 1 - (12-month ECL)	20	(20)	-	-	-
Transfers to Stage 2 - (lifetime ECL)	(8)	8	-	-	-
Transfers to Stage 3 - (credit impaired financial assets)	(3)	(3)	6	-	-
Net remeasurement of loss allowance	(37)	23	3	(6)	(17)
New financial assets, originated or purchased	19	1	-	-	20
Derecognitions and maturities	(4)	(4)	(15)	-	(23)
Write-offs	-	-	(10)	-	(10)
Impairment loss allowance for loans to customers - mortgage loans	147	86	400	64	697

Impairment loss allowance for loan commitments, guarantees and unused credit facilities

1.1.-30.9.2018	Stage 1	Stage 2	Stage 3	Total
ECL balance at 31.12.2017	-	-	58	58
Net remeasurement	180	49	-	229
Opening balance at 1.1.2018	180	49	58	287
Transfers of financial assets				
Transfers to 12-month ECL	66	(36)	(30)	-
Transfers to lifetime ECL	(18)	18	-	-
Transfers to credit impaired financial assets	(22)	(3)	25	-
Net remeasurement of loss allowance	(65)	177	1,963	2,075
New financial assets, originated or purchased	164	8	22	194
Derecognitions and maturities	(125)	(26)	(348)	(499)
Foreign exchange	1	4	20	25
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	181	191	1,710	2,082

1.7.-30.9.2018	Stage 1	Stage 2	Stage 3	Total
Opening balance at 1.7.2018	197	107	42	346
Transfers of financial assets				
Transfers to 12-month ECL	11	(11)	-	-
Transfers to lifetime ECL	(3)	3	-	-
Transfers to credit impaired financial assets	(21)	(1)	22	-
Net remeasurement of loss allowance	(22)	97	1,624	1,699
New financial assets, originated or purchased	61	1	19	81
Derecognitions and maturities	(43)	(8)	-	(51)
Foreign exchange	1	3	3	7
Impairment loss allowance for loan commitments, guarantees and unused credit facilities	181	191	1,710	2,082

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

40. Credit risk, continued

The following table reconciles the opening and closing loss allowance balance as measured under IAS 39. The comparative amounts have not been restated after the implementation of IFRS 9.

31.12.2017	Specific	Collective	Total
Balance at the beginning of the year	18,281	4,557	22,838
Provision for losses	3,029	(1,362)	1,667
Effects due to acquisition of subsidiary*	(8,723)	-	(8,723)
Write-offs	(2,421)	-	(2,421)
Foreign exchange difference	3	-	3
Payment of loans previously written-off	118	-	118
Balance at the end of the period	10,287	3,195	13,482

*At the end of September 2017 Arion Bank became majority owner of United Silicon, see Note 28. Arion Bank had made provision for losses on loans to United Silicon which was eliminated on Group level when United Silicon became a subsidiary of Arion Bank.

Large exposure

A large exposure is defined as an exposure to a group of financially related borrowers which is equal to or exceeds 10% of the Group's eligible capital according to Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. The legal maximum for individual large exposures is 25% of eligible capital, net of eligible credit risk mitigation.

The Group had one large exposure at the end of the period to foreign credit institution. The exposure was 11% of the Group's eligible capital before and after taking account of eligible credit risk mitigation (31.12.2017: no large exposure).

Amounts are in ISK millions

41. Market risk

Market risk is the current or prospective risk that changes in financial market prices and rates adversely affect the Group's earnings and equity position due to changes to the value and cash flows of its assets and liabilities.

Market risk arises from imbalances in the Group's balance sheet as well as in market making activities and position taking in bonds, equities, currencies, derivatives, and other commitments which are marked to market.

The Group keeps close track of market risk and separates its exposures for the trading book and the banking book. Market risk in the trading book arises from market making activities and non-strategic derivatives positions arising from the Bank's operations of meeting customers' investment and risk management needs. Market risk in the banking book arises from various mismatches in assets and liabilities in e.g. currencies, maturities and interest rates. Market risk in the trading book and in the banking book is managed separately.

Market risk allowance is set by the Board in the Bank's risk appetite and limit frameworks are in place for each trading desk. The Asset and Liability Committee (ALCO) is responsible for managing the Bank's overall market risk. Risk Management is responsible for measuring and monitoring market risk exposure, and reporting the exposure, usage and limit breaches.

The Group's strategy towards market risk is to limit the risk exposure due to imbalances in the Group's balance sheet but accept limited risk in its trading book.

Interest rate risk

Interest rate risk arises from the possibility that changes in market rates adversely affect net interest income and fair value of interest-bearing instruments on the Group's balance sheet. The Group's operations are subject to interest rate risk due to mismatches in the fixing of interest rates between assets and liabilities, resulting in a repricing risk for the Group. The Group also faces interest basis risk between interest-bearing assets and interest-bearing liabilities due to different types of floating-rate indices in different currencies.

The Group's interest rate risk for foreign currencies is limited as foreign denominated assets predominantly have short fixing periods and the Group has applied cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common, and this especially applies to indexed mortgages issued between 2004 and 2006. The fixing profile of indexed mortgages is however matched by that of the Group's structured covered bonds issue, which serves as a hedge against repricing risk. The Group has been able to manage relatively small interest fixing gaps.

In the past few years domestic interest rates, nominal and real, have fallen. Due to favorable refinancing spreads, prepayments and/or refinancing of loans have been considerable. Prepayment risk is mitigated by prepayment fees and the Group's own prepayment options. The Group's prepayment of structured covered bonds is a reaction to mortgage prepayments and mortgage refinancing.

Interest rate risk in the banking book

The following table shows the Group's interest-bearing assets and liabilities by interest fixing periods. The figures for loans to customers and borrowings are shown on a fair value basis, see Note 23, and are therefore different from the amounts shown in these Condensed Consolidated Interim Financial Statements. The fair value reflects the likelihood of prepayment. Defaulted loans are presented at book value, which is based on the value of the underlying collateral, and are therefore assumed to be independent of interest adjustment periods and placed in the 'Up to 3 months' category.

30.9.2018 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	89,422	-	-	-	-	89,422
Loans to credit institutions	123,446	-	-	-	-	123,446
Loans to customers	497,656	76,728	137,521	8,931	101,961	822,797
Financial instruments	19,459	11,210	16,718	-	1,909	49,296
Assets	729,983	87,938	154,239	8,931	103,870	1,084,961
Liabilities						
Due to credit institutions and Central Bank	15,370	-	-	-	-	15,370
Deposits	425,609	43,646	13,013	1,352	949	484,569
Borrowings	37,675	56,627	187,743	37,947	114,455	434,447
Liabilities	478,654	100,273	200,756	39,299	115,404	934,386
Derivatives and other off-balance sheet items (net position)	(143,358)	1,389	146,045	(769)	-	3,307
Net interest gap	107,971	(10,946)	99,528	(31,137)	(11,534)	153,882

Amounts are in ISK millions

41. Market risk, continued

31.12.2017						
Assets						
Balances with Central Bank	129,864	-	-	-	-	129,864
Loans to credit institutions	86,609	-	-	-	-	86,609
Loans to customers	440,161	77,099	141,944	5,867	107,114	772,185
Financial instruments	27,342	3,033	8,186	-	1,866	40,427
Assets	683,976	80,132	150,130	5,867	108,980	1,029,085
Liabilities						
Due to credit institutions and Central Bank	7,370	-	-	-	-	7,370
Deposits	427,393	19,453	13,083	1,343	889	462,161
Borrowings	64,533	6,637	187,998	31,293	111,946	402,407
Liabilities	499,296	26,090	201,081	32,636	112,835	871,938
Derivatives and other off-balance sheet items (net position)	(99,372)	114	102,038	1,548	-	4,328
Net interest gap	85,308	54,156	51,087	(25,221)	(3,855)	161,475

Sensitivity analysis of interest rate risk in the banking book

The following table shows the sensitivity of the Group's net present value (NPV) of interest-bearing assets and liabilities and variation of annual net interest income (NII), due to changes in interest rates by currencies. The variation is calculated on the basis of simultaneous parallel shifts upwards or downwards of yield curves. The choice of shifts is not an estimate of risk likelihood. Behavioral maturities are taken into account in the NPV calculations, including prepayment likelihood and expected behavior of non-maturing deposits. The change to NII is however purely based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates.

Interest rates for foreign currencies are predominantly short term for the Group and hedging is applied for fixed rate borrowings. As a result the Group's effective interest income is marginally sensitive to changes to foreign currency interest rates. This is however not fully reflected in the NII variation analysis for 31 December 2017 as a substantial part of the Group's liquid assets in foreign currency was invested in liquidity funds, the income of which is not recognized as interest income.

	30.9.2018		31.12.2017	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(3,420)	2,948	(1,465)	2,411
ISK, Non index-linked	362	864	(76)	742
Foreign currencies	312	(334)	88	(113)

	30.9.2018		31.12.2017	
NII change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(841)	841	(693)	693
ISK, Non index-linked	(46)	46	(429)	429
Foreign currencies	88	(88)	353	(353)

Sensitivity analysis of interest rate risk in the trading book

The following table shows the interest sensitivity of the Group's net positions in the trading book by currencies. Sensitivity is quantified as the net change in value when assuming a simultaneous parallel shift upwards and downwards of all yield curves by 100 basis points. The sensitivity does not relate to variation of annual net interest income and is not an estimate of risk. The calculations are based on duration and convexity in this table.

	30.9.2018		31.12.2017	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	85	(76)	99	(95)
ISK, Non index-linked	107	(102)	19	(14)
Foreign currencies	(175)	166	27	(27)

Amounts are in ISK millions

41. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). Index-linked loans and borrowings are typically annuities, where the principal and monthly payments change in the same proportion as the CPI. The Group is exposed to indexation risk as indexed assets exceed indexed liabilities. Financial instruments held for liquidity or market making purposes are assumed to be on demand.

Book value and maturity profile of indexed assets and liabilities

30.9.2018	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	38,152	71,510	246,330	355,992
Financial instruments	8,084	-	-	8,084
Off-balance sheet position	-	539	-	539
Assets, CPI index-linked	46,236	72,049	246,330	364,615
Liabilities, CPI index-linked				
Deposits	69,805	12,556	2,291	84,652
Borrowings	6,257	16,933	136,920	160,110
Other	863	207	1,364	2,434
Off-balance sheet position	637	3,351	773	4,761
Liabilities, CPI index-linked	77,562	33,047	141,348	251,957
Net on-balance sheet position	(30,689)	41,814	105,755	116,880
Net off-balance sheet position	(637)	(2,812)	(773)	(4,222)
CPI Balance	(31,326)	39,002	104,982	112,658

31.12.2017				
Assets, CPI index-linked				
Loans to customers	16,928	100,149	233,292	350,369
Financial instruments	6,659	-	-	6,659
Off-balance sheet position	4,667	2,096	-	6,763
Assets, CPI index-linked	28,254	102,245	233,292	363,791
Liabilities, CPI index-linked				
Deposits	68,667	12,499	2,201	83,367
Borrowings	1,832	20,867	121,692	144,391
Other	982	203	1,369	2,554
Off-balance sheet position	-	539	-	539
Liabilities, CPI indexed linked	71,481	34,108	125,262	230,851
Net on-balance sheet position	(47,894)	66,580	108,030	126,716
Net off-balance sheet position	4,667	1,557	-	6,224
CPI Balance	(43,227)	68,137	108,030	132,940

Amounts are in ISK millions

41. Market risk, continued

Currency risk

Currency risk is the risk of loss due to adverse movements in foreign exchange rates. The Group is exposed to currency risk through a currency mismatch between assets and liabilities. ISK denominated deposits are a primary source of funding for the Group whereas a substantial part of the Group's assets consists of foreign currency denominated loans to customers. Net exposures per currency are monitored centrally in the Bank.

Breakdown of assets and liabilities by currency

30.9.2018

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	96,887	1,153	432	223	242	96	492	99,525
Loans to credit institutions	21,572	35,148	32,244	4,366	1,534	18,566	10,016	123,446
Loans to customers	665,643	103,742	35,374	3,356	5,713	877	5,260	819,965
Financial instruments	52,526	27,663	25,899	818	56	2,094	318	109,374
Other financial assets	25,812	471	175	827	201	12	12	27,510
Assets	862,440	168,177	94,124	9,590	7,746	21,645	16,098	1,179,820
Liabilities								
Due to credit inst. and Central Bank	11,200	3,079	1,037	3	-	1	50	15,370
Deposits	407,878	40,075	25,670	3,872	1,990	2,706	2,378	484,569
Financial liabilities at fair value	1,736	373	705	49	8	414	96	3,381
Other financial liabilities	45,062	2,669	2,703	2,978	1,010	896	995	56,313
Borrowings	205,144	180,349	-	9	-	22,290	17,809	425,601
Liabilities	671,020	226,545	30,115	6,911	3,008	26,307	21,328	985,234
Net on-balance sheet position	191,420	(58,368)	64,009	2,679	4,738	(4,662)	(5,230)	
Net off-balance sheet position	7,658	53,325	(63,834)	(2,173)	(5,084)	4,821	5,287	
Net position	199,078	(5,043)	175	506	(346)	159	57	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	7,044	-	-	-	-	-	-	7,044
Investments in associates	854	8	-	-	-	-	-	862
Intangible assets	8,933	-	-	2,015	3,091	-	-	14,039
Tax assets	623	-	-	-	-	-	-	623
Non-current assets and disposal groups held for sale	1,593	6,758	-	-	-	-	-	8,351
Other non financial assets	8,289	146	22	273	27	9	24	8,790
Assets	27,336	6,912	22	2,288	3,118	9	24	39,709
Liabilities and equity								
Tax liabilities	6,376	-	-	-	-	-	-	6,376
Other non-financial liabilities	25,913	427	1,468	54	1	-	-	27,863
Shareholders' equity	199,317	-	-	-	-	-	-	199,317
Non-controlling interest	739	-	-	-	-	-	-	739
Liabilities and equity	232,345	427	1,468	54	1	-	-	234,295
Management reporting of currency risk*	(5,931)	1,442	(1,271)	2,740	2,771	168	81	

Amounts are in ISK millions

41. Market risk, continued

31.12.2017

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	137,399	943	293	266	265	117	536	139,819
Loans to credit institutions	17,678	15,033	27,117	8,518	1,910	10,621	5,732	86,609
Loans to customers	624,192	97,687	27,879	3,283	7,245	646	4,169	765,101
Financial instruments	56,240	39,891	11,309	102	9	1,691	208	109,450
Other financial assets	6,023	965	613	1,102	171	24	50	8,948
Assets	841,532	154,519	67,211	13,271	9,600	13,099	10,695	1,109,927
Liabilities								
Due to credit inst. and Central Bank	6,989	292	38	3	-	1	47	7,370
Deposits	412,981	23,792	15,382	3,309	1,349	3,692	1,656	462,161
Financial liabilities at fair value	2,253	1,183	34	27	32	35	37	3,601
Other financial liabilities	20,150	3,870	2,183	5,505	1,393	565	1,039	34,705
Borrowings	181,787	162,486	1,832	14	-	20,794	18,085	384,998
Liabilities	624,160	191,623	19,469	8,858	2,774	25,087	20,864	892,835
Net on-balance sheet position	217,372	(37,104)	47,742	4,413	6,826	(11,988)	(10,169)	
Net off-balance sheet position	(536)	34,743	(46,994)	(1,557)	(9,142)	12,331	11,155	
Net position	216,836	(2,361)	748	2,856	(2,316)	343	986	

Addition, for management reporting

Assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Investment property	6,613	-	-	-	-	-	-	6,613
Investments in associates	752	8	-	-	-	-	-	760
Intangible assets	13,848	-	-	-	-	-	-	13,848
Tax assets	450	-	-	-	-	-	-	450
Non-current assets and disposal groups held for sale	8,138	-	-	-	-	-	-	8,138
Other non-financial assets	7,843	61	34	36	2	19	23	8,018
Assets	37,644	69	34	36	2	19	23	37,827
Liabilities and equity								
Tax liabilities	6,828	-	-	-	-	-	-	6,828
Other non-financial liabilities	22,106	99	30	122	1	-	(1)	22,357
Shareholders' equity	225,606	-	-	-	-	-	-	225,606
Non-controlling interest	128	-	-	-	-	-	-	128
Liabilities and equity	254,668	99	30	122	1	-	(1)	254,919
Management reporting of currency risk*	(188)	(2,391)	752	2,770	(2,315)	362	1,010	

*The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying, such as tax assets and liabilities and intangible assets, as it is considered to be a more accurate measurement of the Group's currency exposure. The net position, as seen by the management, is the position used for managing the currency imbalance.

Amounts are in ISK millions

41. Market risk, continued

Sensitivity analysis on currency risk

The table below indicates the currencies to which the Group had significant exposure at the end of the period. The analysis calculates the effect of a reasonably possible movement of the currency rate against the ISK, with all other variables held constant, on the Consolidated Interim Income Statement (due to the fair value of currency sensitive non-trading monetary assets and liabilities). A negative amount in the table reflects a potential net reduction in the Consolidated Interim Income Statement or equity, while a positive amount reflects a net potential increase. An equivalent decrease in each of the below currencies against the ISK would have resulted in an equivalent but opposite impact (+10% denotes a depreciation of the ISK).

	30.9.2018		31.12.2017	
Currency	-10%	+10%	-10%	+10%
EUR	(144)	144	239	(239)
USD	127	(127)	(75)	75
GBP	(274)	274	(277)	277
DKK	(277)	277	232	(232)
NOK	(17)	17	(36)	36
Other	(8)	8	(101)	101

Equity risk

Equity risk is the risk that the fair value of equities decreases as the result of changes in the level of equity indices and individual stocks. For information on assets seized and held for sale and equity exposures, see Notes 29 and 22 respectively.

Sensitivity analysis of equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices on the Consolidated Interim Income Statement. A negative amount in the table reflects a potential net reduction in the Consolidated Interim Income Statement or equity, while a positive amount reflects a potential net increase. Investments in associates are excluded. The result of value-at-risk calculations for the trading book are shown in the Group's Pillar 3 Disclosures.

	30.9.2018		31.12.2017	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(338)	338	(166)	166
Banking book - listed	(521)	521	(540)	540
Banking book - unlisted	(599)	599	(1,170)	1,170

Derivatives

Derivatives are a part of the Group's customer product offering. The types of derivatives currently offered are forward contracts, swaps and options. Eligible underlying market factors are interest rates, foreign exchange rates, equities and commodities. Exposure limits, hedging requirements and collateral requirements are determined in accordance with the Group's risk appetite and monitored by Risk Management on a daily basis. The Group also uses derivatives to reduce market risk on its balance sheet. Note 23 shows a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

42. Liquidity and Funding risk

Liquidity risk is defined as the risk that the Group, though solvent, either does not have sufficient financial resources available to meet its liabilities when they fall due, or can secure them only at excessive cost. Liquidity risk arises from the inability to manage unplanned decreases or changes in funding sources.

The Group's primary source of funding is deposits from individuals, businesses and financial undertakings. The Group's liquidity risk stems from the fact that the maturity of loans exceeds the maturity of deposits, of which 70% is on-demand.

Liquidity risk is one of the Group's most significant risk factors and a great deal of emphasis is placed on managing it. The Asset and Liability Committee (ALCO) is responsible for managing liquidity and funding risk within the risk appetite set by the Board of Directors. The Bank's Treasury manages liquidity positions on a day-to-day basis. Risk Management measures, monitors and reports the Bank's liquidity and funding risk on a daily basis.

The Group's strategy in relation to liquidity risk is to actively manage its liquidity positions and risks to meet payment and settlement obligations on a timely basis under both normal and stressed conditions. The Group seeks to maintain a stable funding profile which supports its business strategy and liquidity profile, ensuring that the Group can withstand periods of market turbulence, without reliance on volatile funding or external support.

Maturity analysis of assets and liabilities

The maturity analysis is based on contractual cash flows. The amounts are not discounted and include future interest payments, but CPI-linked amounts do not include accrued indexation due to future inflation. The total amount for each item is higher than the corresponding amount on the Bank's balance sheet, since the amounts on the balance sheet are either at amortized cost and do not contain future interest payments, or at fair value where future cash flows have been discounted.

Contractual cash flows differ in many ways from expected cash flows. The difference is most significant for deposits on the liability side and bonds on the asset side. Deposits are always assumed to be withdrawn at the earliest possible date, despite the fact that a large part of the deposit base is considered to be stable funding where behavioral maturity considerably exceeds contractual maturity. Furthermore, although contractual cash flows are presented for bonds held by the Bank, a large portion of the bonds are a part of the Bank's liquidity buffer and are considered to be highly liquid and can be sold and/or pledged to the Central Bank of Iceland and thus converted into cash at short notice.

Contractual cash flow of assets and liabilities

30.9.2018	On	Up to 3	3-12	1-5	Over 5	With no		Carrying
Assets	demand	months	months	years	years	maturity	Total	amount
Cash and balances with CB	12,897	81,441	5,285	-	-	-	99,623	99,525
Loans to credit institutions	74,137	48,406	562	394	-	-	123,499	123,446
Loans to customers	6,516	120,269	109,346	326,746	628,064	-	1,190,941	813,621
Financial instruments	14,066	17,965	12,347	35,583	7,235	29,518	116,714	109,374
Derivatives - assets leg	-	*41,798*	*16,582*	*59,182*	*417*	-	*117,979*	*108,974*
Derivatives - liabilities leg	-	*(40,159)*	*(16,326)*	*(52,296)*	*(326)*	-	*(109,107)*	*(102,621)*
Other financial assets	366	23,211	3,009	924	-	-	27,510	27,510
Assets	107,982	291,292	130,549	363,647	635,299	29,518	1,558,287	1,173,476
Liabilities								
Due to credit inst. and Central Bank ..	12,141	-	3,259	-	-	-	15,400	15,370
Deposits	346,391	87,058	43,639	13,142	2,474	-	492,704	484,569
Financial liabilities at fair value	-	2,234	1,218	4,332	176	-	7,960	3,381
Derivatives - assets leg	-	*(51,944)*	*(5,312)*	*(19,026)*	*(5,191)*	-	*(81,473)*	*(79,496)*
Derivatives - liabilities leg	-	*53,154*	*6,530*	*23,358*	*5,367*	-	*88,409*	*81,853*
Short position bonds and derivatives ..	-	*683*	-	-	-	-	*683*	*683*
Short position securities used for economic hedging	-	*340*	-	-	-	-	*340*	*340*
Other financial liabilities	21,110	36,568	939	2,619	929	-	62,165	62,165
Borrowings	-	17,505	68,807	243,230	187,607	-	517,149	425,601
Liabilities	379,642	143,365	117,862	263,323	191,186	-	1,095,378	991,086
Net position for assets and liab.	(271,660)	147,927	12,687	100,324	444,113	29,518	462,909	182,390
Off-balance sheet items								
Financial guarantees	3,810	1,026	4,770	2,899	3,411	-	15,916	15,916
Unused overdraft	-	45,276	-	-	-	-	45,276	45,276
Undrawn loan commitments	-	59,297	21,823	10,578	-	-	91,698	91,698
Off-balance sheet items	3,810	105,599	26,593	13,477	3,411	-	152,890	152,890
Net contractual cash flow	(275,470)	42,328	(13,906)	86,847	440,702	29,518	310,019	29,500

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

31.12.2017 *Assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Carrying amount
Cash and balances with CB	31,281	99,340	9,362	-	-	-	139,983	139,819
Loans to credit institutions	52,320	34,294	-	-	-	-	86,614	86,609
Loans to customers	2,908	107,790	90,076	336,545	568,833	-	1,106,152	765,101
Financial instruments	8,512	15,082	14,641	20,028	5,926	44,047	108,236	109,450
Derivatives - assets leg	*1,436*	*38,718*	*18,153*	*71,627*	*678*	-	*130,612*	*126,111*
Derivatives - liabilities leg	*(1,423)*	*(37,084)*	*(18,084)*	*(68,879)*	*(585)*	-	*(126,055)*	*(118,487)*
Other financial assets	1,535	5,103	2,224	86	-	-	8,948	8,948
Assets	96,556	261,609	116,303	356,659	574,759	44,047	1,449,933	1,109,927
Liabilities								
Due to credit inst. and Central Bank	7,658	-	26	-	-	-	7,684	7,370
Deposits	331,796	86,524	30,244	13,071	2,246	-	463,881	462,161
Financial liabilities at fair value	-	2,182	(102)	593	(273)	-	2,400	3,601
Derivatives - assets leg	-	*(20,039)*	*(11,449)*	*(14,407)*	*(1,557)*	-	*(47,452)*	*(40,931)*
Derivatives - liabilities leg	-	*20,688*	*11,347*	*15,000*	*1,284*	-	*48,319*	*42,998*
Short position bonds and derivatives	-	*410*	-	-	-	-	*410*	*410*
Short position securities used for economic hedging	-	*1,124*	-	-	-	-	*1,124*	*1,124*
Other financial liabilities	25,538	7,296	28	1,843	-	-	34,705	34,705
Borrowings	-	37,110	23,066	239,210	175,845	-	475,231	384,998
Liabilities	364,992	133,112	53,262	254,717	177,818	-	983,901	892,835
Net position for assets and liab.	(268,436)	128,497	63,041	101,942	396,941	44,047	466,032	217,092
Off-balance sheet items								
Financial guarantees	2,918	2,852	3,164	2,827	1,463	-	13,224	13,224
Unused overdraft	-	45,897	-	-	-	-	45,897	45,897
Undrawn loan commitments	2,966	45,788	17,751	9,559	11,878	-	87,942	87,942
Off-balance sheet items	5,884	94,537	20,915	12,386	13,341	-	147,063	147,063
Net contractual cash flow	(274,320)	33,960	42,126	89,556	383,600	44,047	318,969	70,029

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

Net Stable Funding Ratio

The net stable funding ratio (NSFR) measures the amount of available stable funding (ASF) at the Group against the required stable funding (RSF) as per the definition of the Central Bank of Iceland rules No. 1032/2014. In general, RSF is determined by applying different weights to different asset classes depending on the level of liquidity. ASF however is calculated by applying weights to the Group's liabilities depending on maturity and/or stickiness. The NSFR for foreign currency shall exceed 100%.

Calculations of the NSFR are based on consolidated figures for the Bank and Arion Bank Mortgages Institutional Investor Fund. When calculating the ratio for foreign currencies, a negative foreign currency balance is subtracted from the numerator and a positive balance is subtracted from the denominator. The foreign currency balance used is different from that of this Consolidated Financial Statement due to the sub-consolidation applied.

30.9.2018	ISK	Foreign currency	Total
Available stable funding	666,342	223,954	890,296
Required stable funding	623,275	133,846	757,121
Foreign currency balance		(5,038)	
Net stable funding ratio	107%	164%	118%

31.12.2017			
Available stable funding	663,850	199,770	863,620
Required stable funding	577,761	110,473	688,234
Foreign currency balance		7	
Net stable funding ratio	115%	181%	125%

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is part of the standards introduced in the Basel III Accord. The LCR is the result of a stress test that is designed to ensure that banks have the necessary assets on hand to withstand short-term liquidity disruptions. More accurately, LCR represents the balance between highly liquid assets and the expected net cash outflow of the Group in the next 30 days under stressed conditions.

To qualify as highly liquid assets under the LCR rules, assets must be non-pledged, liquid and easily priced on the market, repo-able at the Central Bank and not issued by the Group or related entities.

The Bank complies with The Central Bank of Iceland's liquidity rules No. 266/2017, which effectively adopt the liquidity rules of the EU Capital Requirements Regulation (CRR). The Bank is required to maintain a 100% minimum LCR ratio for both the aggregate position in all foreign currencies and all currencies.

The following table shows the breakdown for the Group's LCR calculations broken down by currencies. All amounts are weighted by their respective LCR weights. The calculations are based on consolidated figures for the Bank, the Arion Bank Mortgages Institutional Investor Fund and Valitor hf.

30.9.2018	ISK	Foreign currency	Total
Liquid assets level 1 *	85,249	43,140	128,389
Liquid assets level 2	-	-	-
Liquid Assets	85,249	43,140	128,389
Deposits	102,238	42,823	145,061
Borrowing	3,006	109	3,115
Other cash outflows	13,722	15,568	29,290
Cash outflows	118,966	58,500	177,466
Short-term deposits with other banks **	3,445	80,966	84,411
Other cash inflows	14,360	2,761	17,121
Cash inflows	17,805	83,727	101,532
Liquidity coverage ratio (LCR) ***	84%	295%	169%

31.12.2017			
Liquid assets level 1 *	131,197	27,716	158,913
Liquid assets level 2	-	-	-
Liquid Assets	131,197	27,716	158,913
Deposits	108,442	24,738	133,180
Borrowing	2,426	96	2,522
Other cash outflows	6,067	9,500	15,567
Cash outflows	116,935	34,334	151,269
Short-term deposits with other banks **	1,048	59,528	60,576
Other cash inflows	12,232	6,540	18,772
Cash inflows	13,280	66,068	79,348
Liquidity coverage ratio (LCR) ***	127%	323%	221%

* Level 1 assets include the Group's cash and balances with the Central Bank, domestic bonds eligible as collateral at the Central Bank and foreign government bonds which receive 100% weight. Under Rules No. 266/2017 the Group's covered bonds also classify as Level 1 assets and receive 93% weight.

** Short-term deposits with other banks are defined as cash inflows in LCR calculations.

*** LCR is defined as: LCR = Weighted liquid assets / (weighted cash outflows - weighted cash inflows) where weighted cash inflows are capped at 75% of weighted cash outflows.

Amounts are in ISK millions

42. Liquidity and Funding risk, continued

Composition of liquid assets

The following table shows the composition of the Group's liquidity buffer.

30.9.2018	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	96,887	432	1,153	1,053	99,525
Short-term deposits in other banks	3,445	27,969	30,894	22,103	84,411
Domestic bonds eligible as collateral at the Central Bank	2,077	-	-	-	2,077
Foreign government bonds	-	20,010	18,791	733	39,534
Covered bonds with a minimum rating of AA-	-	-	1,299	1,650	2,949
Liquidity reserve	102,409	48,411	52,137	25,539	228,496

31.12.2017	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	137,399	293	943	1,184	139,819
Short-term deposits in other banks	1,048	24,796	15,334	19,398	60,576
Domestic bonds eligible as collateral at the Central Bank	3,022	-	-	-	3,022
Foreign government bonds	-	6,401	16,291	-	22,692
Covered bonds with a minimum rating of AA-	-	-	1,262	1,538	2,800
Liquidity reserve	141,469	31,490	33,830	22,120	228,909

LCR deposit categorization

As per the LCR methodology, the Group's deposit base is split into different categories depending on customer type. A second categorization is used where term deposits refer to deposits with a residual maturity greater than 30 days. Deposits that can be withdrawn within 30 days are marked stable if the customer has a business relationship with the Group and the amount is covered by the Deposit Insurance Scheme. Other deposit funds are considered less stable. A weight is attributed to each category, representing the expected outflow under stressed conditions, i.e. the level of stickiness.

The table below shows the breakdown of the Group's deposit base according to the LCR categorization, with the associated expected stressed outflow weights. The table contains deposits at the Bank and at banking subsidiaries. Thus, amounts due to Central Bank and amounts due to credit institutions at non-banking subsidiaries are excluded.

LCR categorization - amounts and LCR outflow weights

	Deposits maturing within 30 days					
30.9.2018	Less Stable	Weight (%)	Stable	Weight (%)	Term deposits*	Total deposits
Retail	173,928	11%	50,302	5%	74,371	298,601
Corporations	52,963	40%	851	20%	7,060	60,874
Sovereigns, central banks and PSE	17,784	40%	-	-	5,546	23,330
Pension funds	52,214	100%	-	-	12,318	64,532
Domestic financial entities	32,366	100%	-	-	15,634	48,000
Foreign financial entities	4,602	100%	-	-	-	4,602
Total	333,857		51,153		114,929	499,939
31.12.2017						
Retail	163,542	11%	52,401	5%	68,741	284,684
Corporations	51,968	40%	811	20%	5,757	58,536
Sovereigns, central banks and PSE	14,583	40%	-	-	1,383	15,966
Pension funds	53,116	100%	-	-	15,391	68,507
Domestic financial entities	23,175	100%	-	-	15,949	39,124
Foreign financial entities	2,714	100%	-	-	-	2,714
Total	309,098		53,212		107,221	469,531

* Here term deposits refer to deposits with maturities greater than 30 days.

Amounts are in ISK millions

43. Capital management

Capital adequacy

The focus of capital management at the Group is to normalize the capital structure in the medium term and consequently maintain the Group's capitalization comfortably above the regulatory requirement, including capital buffers and Pillar 2 requirements.

The Group's capital ratios are calculated in accordance with Act No. 161/2002 on Financial Undertakings and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR), but has temporarily excluded Article 501 on capital requirements relief for small and medium enterprises. The Group uses the standardized approach to calculate capital requirements for credit risk, credit valuation adjustment, market risk and operational risk.

The Group's consolidated situation as stipulated in CRR is the Group's accounting consolidation excluding insurance subsidiaries. The capital position and solvency requirements of Vörður tryggingar hf. should be viewed independently from capital adequacy for the Group's consolidated situation.

Own funds	30.9.2018	31.12.2017
Total equity	200,056	225,734
Deductions related to the consolidated situation	(8,573)	(8,635)
Non-controlling interest not eligible for inclusion in CET 1 capital	(739)	(128)
Common Equity Tier 1 capital before regulatory adjustments	190,744	216,971
Intangible assets	(11,445)	(11,125)
Tax assets	(564)	(357)
Indirect holdings of own CET1 instruments	(190)	-
Cash flow hedges	(999)	265
Additional value adjustments	(119)	(119)
Foreseeable dividend*	(2,775)	(25,000)
Common equity Tier 1 capital	174,652	180,635
Non-controlling interest not eligible for inclusion in CET 1 capital	739	128
Tier 1 capital	175,391	180,763
General credit risk adjustments**	-	3,195
Tier 2 capital	-	3,195
Total own funds	175,391	183,958

Risk-weighted assets		
Credit risk, loans	646,016	605,058
Credit risk, securities and other	51,133	56,979
Counterparty credit risk	4,461	5,844
Market risk due to currency imbalance	7,305	4,895
Market risk other	9,717	5,473
Credit valuation adjustment	2,235	2,506
Operational risk	86,013	86,013
Total risk-weighted assets	806,880	766,768

Capital ratios		
CET 1 ratio	21.6%	23.6%
Tier 1 ratio	21.7%	23.6%
Capital adequacy ratio	21.7%	24.0%
CET1 ratio, based on reviewed retained earnings at 30 June	21.6%	
Tier 1 ratio, based on reviewed retained earnings at 30 June	21.7%	
Capital adequacy ratio, based on reviewed retained earnings at 30 June	21.7%	

* On 30 September 2018, the foreseeable dividend consists of 50% of the accumulated net earnings attributable to shareholders of Arion Bank hf. in 2018 which reflects the Bank's dividend policy. At 31 December 2017 the amount is the equity reduction executed in the first quarter of 2018 through purchase of own shares and dividend distribution.

** Under IAS 39, the Bank's general provisions accounted as Tier 2 capital as stipulated in CRR. As per EBA's opinion, all provisions under IFRS 9 are considered specific credit risk adjustments (SCRA). FME has adopted this opinion - as a result the Group's own funds no longer include general credit risk adjustments and these are now treated as SCRA, effectively reducing risk-weighted assets.

Capital ratios of the parent company		
CET 1 ratio	23.7%	26.0%
Tier 1 ratio	23.7%	26.0%
Capital adequacy ratio	23.7%	26.4%

Amounts are in ISK millions

43. Capital management, continued

The following table outlines the implementation of the capital buffer requirements in accordance with the Financial Undertakings Act, as prescribed by the Financial Stability Council and approved by the FME.

Capital buffer requirement, % of RWA	Current	1.5.2019
Capital conservation buffer	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%
Countercyclical capital buffer *	1.25%	1.75%
Combined capital buffer requirement	8.75%	9.25%

The Bank carries out an ongoing process, the Internal Capital Adequacy Assessment Process (ICAAP), with the aim to ensure that the Group has in place sufficient risk management processes and systems to identify, manage and measure the Group's total risk exposure. The ICAAP is aimed at identifying and measuring the Group's risk across all risk types and ensure that the Group has sufficient capital in accordance with its risk profile. The FME supervises the Group, receives the Group's internal estimation on the capital adequacy and sets capital requirements for the Group as a whole following the Supervisory Review and Evaluation Process (SREP). The Group's own funds exceeds the FME's SREP requirements.

The Bank's Pillar 2R capital add-on, which is the result of the ICAAP/SREP, may comprise 56.25% CET1 capital, 18.75% AT1 capital and 25% Tier 2 capital.

Capital requirement, % of RWA, current

30.9.2018	CET 1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.6%	2.2%	2.9%
Combined buffer requirement *	8.4%	8.4%	8.4%
Regulatory capital requirement	14.6%	16.6%	19.3%
Available capital	21.6%	21.7%	21.7%

Capital requirement, % of RWA, 1.5.2019	CET 1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.6%	2.2%	2.9%
Combined buffer requirement *	8.9%	8.9%	8.9%
Regulatory capital requirement	15.0%	17.1%	19.8%
Available capital	21.6%	21.7%	21.7%

*The effective capital buffers for systemic risk and countercyclical effects are determined by calculating the weighted average of the corresponding buffer levels of each country (if recognized by the FME), the weights being the total risk weighted exposures for credit risk against counterparties residing in those countries.

** The SREP result based on the Group's financial statement at 31.12.2017. The Pillar 2 requirement is 2.9% of risk-weighted assets based on the Group's prudential consolidation under CRR, which excludes Vörður tryggingar hf.

Leverage ratio

The leverage ratio is seen as a complementary measure to the risk-based capital ratios. The ratio is calculated on the basis of the Group's consolidated situation as per the CRR, which excludes the Group's insurance subsidiaries. The minimum leverage ratio requirement is 3% as stated in Act No. 161/2002 on Financial Undertakings.

	30.9.2018	31.12.2017
On-balance sheet exposures	1,167,238	1,074,207
Derivative exposures	8,279	10,957
Securities financing transaction exposures	9,382	8,925
Off-balance sheet exposures	82,415	83,058
Total exposure	1,267,314	1,177,147
Tier 1 capital	175,385	180,763
Leverage ratio	13.8%	15.4%

Solvency II

According to the Icelandic Insurance Companies Act the solvency capital requirement (SCR) of Vördur Group was ISK 3,679 million at 30 June 2018 (31.12.2017: ISK 3,503 million) and calculated solvency of Vördur Group was ISK 5,418 million (31.12.2017: ISK 4,949 million). The solvency ratio, which is the ratio of calculated solvency to the solvency requirements was 147% at 30 June 2018 (31.12.2017: 141%).

Amounts are in ISK millions

Notes to the Condensed Consolidated Interim Financial Statements

Significant accounting policies

The accounting policies adopted in the preparation of these Condensed Consolidated Interim Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year ended 31 December 2017 except for changes due to implementation of new accounting standards.

The Group adopted IFRS 9 Financial Instruments on 1 January 2018. As a result of the implementation, the Group changed the accounting policies in the areas outlined below regarding classification of financial assets and impairment calculations. The Group has elected to continue to apply the hedge accounting principles under IAS 39 instead of those under IFRS 9. The new policies were applicable from January 1, 2017. As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative figures; Accordingly, all comparative periods are presented in accordance with IAS 39. For further detail on the accounting policy under IAS 39 see the Groups Annual Financial statements 2017. Adjustments to carrying amounts of financial assets and liabilities at the date of initial application were recognized in Retained earnings and Other reserves within Equity. New or amended interim disclosures have been provided for the period, where applicable, and comparative period disclosures are consistent with those made in prior year. For further information, see Financial assets and Financial liabilities classification transition from IAS 39 to IFRS 9.

On 1 January 2018 the Group adopted IFRS 15 Revenue from contracts with customers. The standard introduces a five-step approach to determine how and when to recognize revenue, but it does not impact the recognition of income from financial instruments, insurance contracts or leasing contracts. The standard also establishes principles for reporting useful information about the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The Group adopted the requirements using the modified retrospective method, with the effect of initial application recognized on the date of initial application and without restatement of the comparative periods. The adoption of IFRS 15 had minor impacts on the Statement of Comprehensive Income.

44. Going concern assumption

IFRS 9 replaces IAS 39 for annual periods on or after 1 January 2018. The Group elected, as a policy choice permitted under IFRS 9, to continue to apply hedge accounting in accordance with IAS 39. The Group has not restated comparative information for 2017 for financial instruments in the scope of IFRS 9. Therefore, the comparative information for 2017 is reported under IAS 39 and is not comparable to the information presented for 2018. The net income of ISK 942 million arising from the adoption of IFRS 9 have been

45. Financial assets and financial liabilities - Classification and Measurement

Recognition and initial measurement

The Group initially recognizes financial assets and financial liabilities on the date that they are originated at the fair value of consideration paid. Regular-way purchases and sales of financial assets are recognized on the trade date at which the Group commits to purchase or sell assets. All other financial assets and liabilities are recognized on the trade date, which is the date that the Group becomes a party to the contractual provision of the instrument.

A financial asset or financial liability is measured initially at fair value plus, for an item not at fair value through profit or loss, transaction cost that are directly attributable to its acquisition or issue. Financial assets include both debt and equity instruments.

Debt instruments

Debt instruments, including loans and debt securities, are classified into one of the following measurement categories:

- amortized cost;
- fair value through profit and loss (FVTPL)
- fair value through other comprehensive income (FVOCI)

A debt instrument is measured at amortized cost only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows; and
- its contractual cash flows are solely payments of principal and interest (SPPI).

A debt instrument is measured at FVOCI only if it meets both of the following conditions and is not designated as at FVTPL:

- it is held within a business model whose objective is to collect contractual cash flows and selling financial assets; and
- its contractual cash flows are SPPI.

All other debt instruments are carried at FVTPL.

Business model assessment

Business model assessment involves determining whether financial assets are managed in order to generate cash flows from collection of contractual cash flows, selling financial assets or both. The Group assesses the business model at a portfolio level reflective of how groups of assets are managed together to achieve a particular business objective. For the assessment of business models the Group takes into consideration the following factors:

- how the performance of assets in a portfolio is evaluated and reported to group heads and other key decision makers within the Group's business lines

45. Financial assets and financial liabilities - Classification and Measurement, continued

- the risks that affect the performance of assets held within a business model and how those risks are managed;
- whether the assets are held for trading purposes, i.e. assets that the Group acquires or incurs principally for the purpose of selling or repurchasing in the near term, or holds as part of a portfolio that is manage together for short-term profit or position taking;
- how compensation is determined for the Group's business lines' management that oversee the assets; and
- the frequency and volume of sales in prior periods and expectations about future sales activity.

Cash flow characteristics assessment

The contractual cash flow characteristics assessment involves assessing the contractual features of an instrument to determine if they give rise to cash flows that are consistent with a basic lending arrangement. Contractual cash flows that are consistent with a basic lending arrangement are considered SPPI.

Interest is defined as consideration for the time value of money and the credit risk associated with the principal amount outstanding and for other basic lending risks and costs (expected losses, liquidity risk and administrative costs), as well as a profit margin. Indexation of loans to the Consumer Price Index (CPI) are considered part of interest as CPI guarantees the time value of money of the original outstanding balance. Principal may change over the life of the instruments due to repayments. Indexation on principal accumulates over time.

In performing this assessment, the Group takes into consideration contractual features that could change the amount or timing of contractual cash flows, such that the cash flows are no longer consistent with a basic lending arrangement. If the Group identifies any contractual features that could modify the cash flows of the instruments such that they are no longer consistent with a basic lending arrangement, the related financial assets is classified at FVTPL.

Debt instruments measured at amortized cost

Debt instrument are measured at amortized cost if they are held within a business model whose objective is to hold for collection of contractual cash flows where those cash flows represent solely payments of principal and interest. After initial measurement, debt instruments in this category are carried at amortized cost using the effective interest rate method. The effective interest rate is the rate that discounts estimated cash payments or receipt through the expected life of the financial asset to the gross carrying amount of a financial asset. Amortized cost is calculated taking into account any discount or premium on acquisition, transaction cost and fees that are an integral part of the effective interest rate. Amortization is included in interest income in the Consolidated Statement of Comprehensive Income.

Impairment on debt instruments measured at amortized cost is calculated using the expected credit loss approach. Loans and debt securities measured at amortized cost are presented net of allowance for credit losses (ACL) in the Consolidated Statement of Financial Position

Debt instruments measured at FVOCI

Debt instrument are measured at FVOCI if they are held within a business model whose objective is to hold for collection of contractual cash flows and selling financial assets, where the assets' cash flows represent payments that are solely payments of principal and interest. Subsequent to initial recognition, unrealized gains and losses on debt instruments measured at FVOCI are recorded in Other Comprehensive Income (OCI), unless the instrument is designated in a fair value hedge relationship. When designated in a fair value hedge relationship any changes in fair value due to changes in the hedged risk is recognized in Non-interest income in the Consolidated Statement of Comprehensive Income on an average cost basis. Foreign exchange gains and losses that relate to the amortized cost of the debt instrument are recognized in the Consolidated Statement of Comprehensive Income. Premiums, discount and related transaction costs are amortized over the expected life of the instrument to interest income in the Consolidated Statement of Comprehensive Income using the effective interest rate method.

Impairment on debt instruments measured at FVOCI is calculated using the expected credit loss approach. The ECL on debt instruments measured at FVOCI does not reduce the carrying amount of the asset in the Statement of Financial Position, which remains at its fair value. Instead, an amount equal to the allowance that would arise if the assets were measured at amortized cost is recognized in OCI whit a corresponding charge to net impairment in the Consolidated Statement of Comprehensive Income. The accumulated allowance recognized in OCI is recycled to the Consolidated Statement of Comprehensive Income upon derecognition of the debt instrument.

Debt instruments measured at FVTPL

Debt instrument are measured at FVTPL if they are held for trading purposes, assets and liabilities held as part of a portfolio managed on a fair value basis and assets whose cash flow do not represent payments that are solely payments of principal and interest. These instruments are measured at fair value in the Consolidated Statement of Financial Position. Realized and unrealized gains and losses are recognized as part of Net financial income in the Consolidated Statement of Comprehensive Income.

45. Financial assets and financial liabilities - Classification and Measurement, continued

Equity instruments

Equity instruments are measured at FVTPL unless an election is made to designate them at FVOCI at initial recognition.

For equity instruments measured at FVTPL, changes in fair value are recognized as part of non-interest income in the Consolidated Statement of Comprehensive Income.

The Group can elect to classify non-trading equity instruments at FVOCI. This election will be used for certain equity instruments for strategic or longer term investment purposes. The FVOCI election is made upon initial recognition, on an instrument-by-instrument basis and once made is irrevocable. Gains and losses on these instruments including when derecognized/sold are recorded in OCI and are not subsequently reclassified to the Consolidated Statement of Comprehensive Income. Dividends received are recorded in Interest income in the Consolidated Statement of Comprehensive Income. Any transaction costs incurred upon purchase of the security are added to the cost basis of the security and are not reclassified to the Consolidated Statement of Comprehensive Income of the security.

Financial assets and liabilities designated at FVTPL

Financial assets and financial liabilities classified in this category are those that have been designated by the Group on initial recognition.

Financial assets are designated at FVTPL if doing so eliminates or significantly reduces an accounting mismatch which would otherwise arise.

Financial liabilities are designated at FVTPL when one of the following criteria is met:

- The designation eliminates or significantly reduces an accounting mismatch which would otherwise arise; or
- The financial liability contains one or more embedded derivatives which significantly modify the cash flows otherwise required.

Financial assets and financial liabilities designated at FVTPL are recorded in the Consolidated Statement of Financial Position at fair value. For assets designated at FVTPL, changes in fair value are recognized in Non-interest income in the Consolidated Statement of Comprehensive Income. For liabilities designated at fair value through profit or loss, all changes in fair value are recognized in Non-interest income in the consolidated statement of Comprehensive Income, except for changes in fair value arising from changes in the Bank's own credit risk which are recognized in OCI. Changes in fair value of liabilities due to changes in the Bank's own credit risk, which are recognized in OCI, are not subsequently reclassified to the Consolidated Statement of Comprehensive Income upon derecognition/extinguishment of the liabilities.

Purchased loans

All purchased loans are initially measured at fair value on the date of acquisition. As a result no allowance for credit losses would be recorded in the Consolidated Statement of Financial Positions on the date of acquisition. Purchased loans may fit into either of the two categories: Performing loans or Purchased or Originated Credit Impaired (POCI) loans.

Purchased performing loans are reflected in Stage 1 and will follow the same accounting as other performing loans. They will be subject to a 12-month allowance for credit losses at the end of the first reporting period after acquisition date which is recorded as provision for credit losses in the Consolidated Statement of Comprehensive Income. The fair value adjustments set up for these loans on the date of acquisition is amortized into interest income over the life of these loans.

POCI loans do not have allowance at initial recognition but subsequently the allowance will reflect the changes in the lifetime expected losses. At recognition the discount of each POCI loan is split up into two categories, impairment discount and interest discount or premium. Interest is calculated with a credit adjusted effective interest rate and is posted to interest income. Periodically the Group recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original credit adjusted effective interest rate, any changes in the expected cash flows since the date of acquisition are recorded as a charge/recovery in net impairment in the Consolidated Statement of Comprehensive Income at the end of all reporting periods

Expected credit losses

Expected credit loss (ECL) is established for all financial assets, except for financial assets classified or designated as FVTPL and equity instruments designated as FVOCI, which are not subject to impairment assessment. Assets subject to impairment assessment include debt instruments (including loans to customers) measured at amortized cost or FVOCI, lease receivables, loan commitments and financial guarantee contracts. ECL on financial assets is presented in Net impairment. Other financial assets carried at amortized cost are presented net of ECL in the Group's Consolidated Statement of Financial Position. Off-balance sheet items subject to impairment assessment include financial guarantees and undrawn loan commitments. ECL for Off-balance sheet items is separately calculated and included in Other Liabilities.

Notes to the Condensed Consolidated Interim Financial Statements

45. Financial assets and financial liabilities - Classification and Measurement, continued

The Group measures the ECL on each balance sheet date according to a three-stage expected credit loss impairment model:

Stage	Criteria	Assessment of expected credit loss, and effective interest
1	Exposures not impaired and with no significant increase in credit risk	12 month expected credit loss is recorded. The expected credit loss is computed using a probability of default occurring over the next 12 months. For those instruments with a remaining maturity of less than 12 months, a probability of default corresponding to remaining term to maturity is used. The effective interest rate is calculated on the gross carrying amount.
2	Exposures not impaired with significant increase in credit risk subsequent to origination.	Lifetime expected credit loss is recorded, based on the probability of default over the remaining estimated life of the financial instrument. Effective interest rate is calculated on the gross carrying amount.
3	Exposures in default / Credit impaired	Lifetime expected credit loss is recorded. Effective interest rate is calculated on the book value.

The ECL is a discounted probability-weighted estimate of the cash shortfalls expected to results from defaults over the relevant time horizon.

The ECL is a discounted probability-weighted estimates of the cash shortfalls expected to results from defaults over the relevant time horizon. For guarantees and loan commitments, credit loss estimates consider the portion of the commitment that is expected to be paid out or expected to be drawn over the relevant time period.

Increases or decreases in the required ECL attributable to purchases and new originations, derecognitions or maturities, and remeasurements due to changes in loss expectations or state migrations are recorded in net impairment. Write-offs and recoveries of amounts previously written off are recorded against ECL.

The ECL represents an unbiased estimate of expected credit losses on our financial assets as at the balance sheet date. Judgement is required in making assumptions and estimations when calculating the ECL, including movements between the three stages and the application of forward looking scenarios. The underlying assumptions and estimates may results in changes to the provisions from period to period that significantly affect our results of operations.

Definition of default

The Group considers a financial assets to be in default when:

- the borrower is more than 90 days past due, or
- the borrower is considered to be unlikely to pay.

In assessing whether a borrower is unlikely to pay, the Group considers both qualitative and quantitative indicators, e.g. overdue status, debt and equity ratios, market circumstances and other data developed internally or obtained from external sources.

For corporate counterparties it is assumed that if one exposure is in default, all other exposures to that counterparty are also in default (cross-default). For individuals however, mortgages and other exposures are assessed separately, meaning that if an individual is in default on a mortgage, his other exposures are not assumed to be in default, and vice versa. A default event for a mortgage can however be an indicator on the likelihood of default for the borrower’s other exposures, and vice versa.

Frequent default events within a year are treated as a single default event. A defaulted exposure is considered to be cured if it has returned to non-default state, with no amount in arrears, within 12 months from default and without any incurred loss for the Group.

Probability of default and credit risk rating

The Group allocates to each exposure a credit risk rating (e.g. A+, A, A-, BBB+, etc.) based on the calculated 12 month probability of default ('the PD'). The PD is assessed through the Group's credit rating models or based on external ratings if available. The Group's credit rating models are statistical models based on a variety of information that has been determined to be predictive of default. These include demographic, behavioral, financial and economic data, coupled with qualitative expert judgement for large corporate exposures. Factors vary depending on the nature of the exposure and the profile of the borrower. The PD estimates used for the purpose of calculating IFRS 9 impairments are point-in-time, i.e. dependent on the economic cycle. The Group's credit rating models are subject to annual performance tests and are recalibrated on a regular basis if needed.

45. Financial assets and financial liabilities - Classification and Measurement, continued

The Group's rating scale is shown below.

Risk class	Rating	Lower PD	Upper PD
1	A+	0.00%	0.07%
	A	0.07%	0.11%
	A-	0.11%	0.17%
	BBB+	0.17%	0.26%
	BBB+	0.26%	0.41%
	BBB-	0.41%	0.64%
2	BB+	0.64%	0.99%
	BB	0.99%	1.54%
	BB-	1.54%	2.40%
3	B+	2.40%	3.73%
	B+	3.73%	5.80%
	B-	5.80%	9.01%
4	CCC+	9.01%	31.00%
	CCC-	31.00%	99.99%
5	DD	99.99%	100.00%

The Group uses external ratings for counterparties that receive such ratings from recognized rating agencies such as Moody's and Standard & Poor's. The external rating is reviewed with a level of professional judgement to allocate a probability of default. External ratings are primarily used to assess expected losses for counterparties of marketable securities, money market and deposit accounts positions which fall under the Impairment requirements of IFRS 9. The Bank's ECL is broken down by investment grade and non-investment grade classes for such exposures, as per the definition of the corresponding rating agency.

Each exposure is allocated a credit risk rating at initial recognition. The calculations are based on rules and available information at the time of origination. Exposures are continuously monitored and revaluated, which may result in transitions between risk ratings. The monitoring typically involves the use of credit history, audited financial statements, management accounts, budgets, KPI's, projections, quality of management, data from credit reference agencies, overdue status and other qualitative and quantitative information available.

PD term structures

In addition to calculating PD and allocating a credit risk rating to each exposure, the Group calculates the lifetime probability of default (LPD), which is an assessment of the probability that a default event occurs over the lifetime of the exposure. The LPD incorporates management's view of possible future macroeconomic developments and the likelihood of rating transitions over the lifetime of the exposure. For the determination of LPD, the Bank calculates PD term structures – which effectively provides the probability of default for any given time period, one for each rating grade, PD model and economic scenario. The annualized lifetime probability of default (ALPD) of an exposure is the fixed 12 month PD (without transitions) that corresponds to the exposure's LPD. The credit risk rating that corresponds to the ALPD is defined as the lifetime credit risk rating.

The assessed 12 months PDs are the basis for the determination of the term structure of PDs for exposures. The Group applies transition models, developed on the basis of historical data, to predict the development of risk grades for periods that exceed one year. The Group has separated transition behavior due to specific and general risk and applies its macro-economic forecasts to the latter. The analysis of credit rating transitions due to general risk includes the identification and calibration of relationships between changes in default rates and changes in key macro-economic factors. Unemployment rate is the predominant predictive variable. Among other indicators examined are GDP growth and benchmark interest rates.

Assumptions on key macro-economic indicators are on an ongoing basis estimated based on internal and external information available at each time. The Group formulates a 'base case' view of the future direction of relevant economic variables as well as a representative range of other possible forecast scenarios. The Group uses these forecasts to adjust its estimates of lifetime probability of default and other factors that affect the lifetime expected credit loss.

Amounts are in ISK millionS

45. Financial assets and financial liabilities - Classification and Measurement, continued

Significant increase in credit risk

The assessment of significant increase in credit risk requires significant judgment. In determining whether the risk of default for an exposure has increased significantly since initial recognition, the Group considers relevant, reasonable and supportable information on an ongoing basis. Assumptions are drawn based on the Group's historical experience and expert judgement including forward-looking expectations. If a debt investment security has low credit risk and is considered investment grade at 31 March 2018, the Group will determine that the credit risk on the asset has not increased significantly since initial recognition.

For a given exposure, the Group considers a significant increase in credit risk to have occurred if one of the following holds:

- the exposure's credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk rating compared to the credit risk rating at origination;
- the exposure's lifetime credit risk rating on reporting date is not in risk class 1 and has deteriorated by more than one risk grade (two or more) compared to the lifetime credit risk rating at origination. As the Group does not have the benefit of hindsight, this comparison is only used for exposures that originate on or after 1 January 2018;
- the number of days in arrears exceeds 30 days; or
- the exposure is on the Group's watch list.

The Group monitors the effectiveness of the criteria used to identify significant increases in credit risk by regular reviews to confirm that the criteria is capable of identifying significant increases in credit risk before an exposure is in default and there is no unwarranted volatility in loss allowance from transfers between 12-month ECL (stage 1) and lifetime ECL (stage 2).

Exposures in default

At each reporting date the Group assesses whether there is objective evidence that financial assets not carried at fair value through profit or loss are impaired. Financial assets are impaired when objective evidence demonstrates that a loss event has occurred after the initial recognition of the assets, and that the loss event has an impact on the future cash flows on the asset that can be estimated reliably.

Objective evidence that financial assets are impaired can include significant financial difficulty of the borrower or issuer, default or delinquency by a borrower, restructuring of a loan or advance by the Group on terms that the Group would not otherwise consider, indications that a borrower or issuer will enter bankruptcy, the disappearance of an active market for a security, or other observable data relating to a group of assets such as adverse changes in the payment status of borrowers or issuers in the group, or economic conditions that correlate with defaults in the group.

- the Group's aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely distribution available on liquidation or bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realizable value of collateral (or other credit mitigates) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

The amount of the loss impaired is the difference between the assets' carrying value and the present value of estimated future cash flow. In some instances exposures do not require impairment, this is because there is a good level of collateral.

Impairment losses are recognized in net impairment and reflected in note 40. When an event occurring after the impairment was recognized causes the amount of impairment loss to decrease, the decrease in impairment loss is reversed through net impairment.

Expected credit loss measurement

The expected credit loss (ECL) calculations are based on three main components:

- probability of default (PD),
- loss given default (LGD); and
- exposure at default (EAD).

Each component is derived from internally generated models, apart from external credit ratings. The models are developed with statistical methods and/or expert judgement supported by historical data and adjusted for expected macro-economic effects.

The Group's PDs and PD term structures are based on both quantitative and qualitative factors and in some cases external ratings are used. PD's are re-assessed on a regular basis with different frequencies depending on the type of counterparty and/or exposure.

The LGD is an assessment of loss conditional on a default occurrence. The Group splits LGD into three components; the probability of cure, the expected recovery from liquidation of collateral, and the recovery rate for the unsecured part of the exposure. The collateral gap assessment is the outcome of The Group’s collateral allocation algorithm, where haircuts are applied to different types of collaterals. Such models are based on expert judgement, supported by historical data, and takes into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations.

45. Financial assets and financial liabilities - Classification and Measurement, continued

The EAD represents the expected exposure at the event of a default. For a given exposure, The Group derives the EAD from the contractual amortization schedule and taking into account the likelihood of pre-payments, drawdowns, rollovers, extensions and use of unused allowance in the period leading up to default. These behavioral estimates, which are based on historical observations and forward-looking forecasts, apply differently to each type of exposure.

The Group measures ECL considering the risk of default over the maximum contractual period (including any extension periods) over which it is exposed to credit risk. The maximum contractual period extends to the date at which the Group has the right to require repayment of an advance or terminate a loan commitment or guarantee. However, for overdrafts and credit card facilities that include both a loan and an undrawn commitment component, the Group measures ECL over a period longer than the maximum contractual period if the Group’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the Group’s exposure to credit losses to the contractual notice period. These facilities do not have a fixed term or repayment structure. The Group can cancel them with immediate effect but this contractual right is not enforced in the normal day-to-day management, but only when the Group becomes aware of an increase in credit risk at the facility level. This longer period is estimated taking into account the credit risk management actions that the Group expects to take and that serve to mitigate ECL. These include a reduction in limits, cancellation of the facility and/or turning the outstanding balance into a loan with fixed repayment terms. The ECL calculations involve discounting using the exposures' effective interest rates.

Forward looking scenarios

The ECL for an exposure is the weighted average of the expected credit loss for different macro-economic scenarios provided by the Group's management. The Group currently considers three scenarios: 'base case', 'optimistic' and 'pessimistic' and assign its best estimate of likelihood of occurrence to each one. The development of macro-economic variables and the corresponding weights are based on expert judgement supported by historical data. The Group incorporates forward-looking macro-economic information into both its assessment of whether the credit risk of an instrument has increased significantly since its initial recognition (via the lifetime credit risk rating comparison) and its measurement of ECL as the PD term structures, LGD and EAD include macro-economic adjustments for each of the scenarios.

The predominant macro-economic variable used across all portfolios is the unemployment rate in Iceland, as measured by the Directorate of Labor. The default rate observed for the Group's exposures has been shown to be highly correlated with unemployment rate. Collateral haircuts are adjusted for different scenarios. Exit and pre-payment rates, which affects EAD, are dependent on refinancing spreads and due to the correlation between interest rates and unemployment rate they are adjusted for different scenarios.

Write-off of loans

Loans are written off, either partially or in full, when there is no realistic prospect of recovery of these amounts and, for collateralized loans, when the proceeds from the realization of collateral have been received.

Modifications

The original terms of a financial asset may be renegotiated or otherwise modified, resulting in changes to the contractual terms of the financial asset that affect the contractual cash flow. The treatment of such modifications is primarily based on the process undertaken to execute the renegotiation and the nature and extent of changes expected to result. Modifications which are performed for credit reasons, primarily related to troubled debt restructurings, are generally treated as modifications of the original financial asset. Modification which are performed for other than credit reasons are generally considered to be an expiry of the original cash flows; accordingly, such renegotiations are treated as a derecognition of the original financial asset and recognition of a new financial asset.

If a modification of terms does not result in derecognition of the financial asset, the carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows, discounted at the original effective interest rate and gain or loss is recognized. The financial asset continues to be subject to the same assessments for significant increase in credit risk relative to initial recognition and credit-impairment, as described above. A modified financial asset will migrate out of Stage 3 if the conditions that led to it being identified as credit-impaired are no longer present and relate objectively to an event occurring after the original credit-impairment was recognized. A modified financial asset will migrate out of Stage 2 when it no longer satisfies the relative thresholds set to identify significant increase in credit risk, which are based on changes in its lifetime PD, days past due and other qualitative considerations.

If a modification of terms results in derecognition of the original financial asset and recognition of the new financial asset, the new financial asset will generally be recorded in Stage 1, unless it is determined to be credit-impaired at the time of renegotiation. For the purposes of assessing for significant increase in credit risk, the date of initial recognition for the new financial asset is the date of modification.

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