



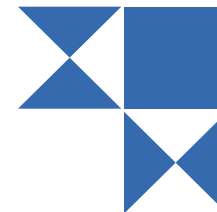
# Arion Bank

*Financial Statements for 2010*

*Creditors' Report Update Meeting*

*March 9, 2011*

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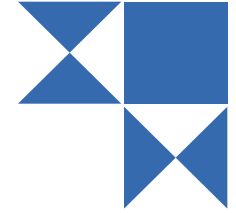


*2010 in brief*





# 2010 in brief



## Changes in ownership, governance and strategic vision

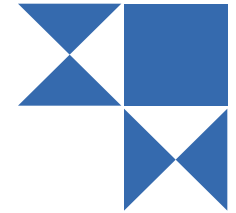
### *Ownership and governance*

- Ownership structure finalized with capital injection on 8 January.
- Kaupskil, a subsidiary of Kaupthing Bank, holds 87% of the share capital in Arion Bank and Icelandic State Financial Investments, holds 13% on behalf of the Ministry of Finance.
- Following the change in ownership a new Board of Directors took the helm, led by Chairwoman Monica Caneman.
- Höskuldur H. Ólafsson was appointed CEO and joined the Bank on 1 June 2010.
- Several new people joined the Bank's management team.

### *Strategy and vision*

- The long-term strategic direction for the Bank was set after extensive groundwork by the management with assistance from McKinsey.
- Arion Bank aims to be a relationship bank with its prime focus on delivering personalized services and tailored solutions to larger corporations and individuals who seek a broad spectrum of financial solutions.
- The Bank's goal is to occupy a leading position on the domestic financial market in terms of return on equity, operational efficiency and service offerings.

# 2010 in brief cont. (1)



Emphasis on the restructuring of the loan book and the sale of acquired companies

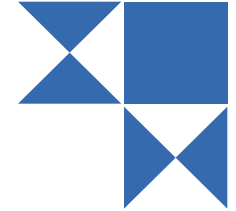
## *Restructuring of the loan book*

- More than 14,000 of the Bank's retail customers took advantage of solutions on offer to lower their monthly payments or adjust the loan principal.
- More than 550 corporations entered the debt restructuring process and a conclusion was reached in the case of 400.
- Arion Bank has made good progress in the restructuring of larger corporations and is now focusing on smaller and medium-sized companies.
- Arion Bank was signatory to an agreement between various financial institutions, governmental bodies, pension funds and industry associations whose aim was to adopt a coordinated approach to the debt restructuring of individuals and corporations.
- Debt restructuring solutions which formed the basis of the agreement are fully in line with solutions that Arion Bank has been offering its customers.

## *Sale of acquired companies*

- A core stake in Hagar, the largest retailer in Iceland which Arion Bank acquired in 2009, was put up for sale in 2010 in an open sales process. The sale of a 34% stake was finalized in February 2011.
- The car dealership Hekla was put up for sale in the second half of 2010 in an open sales process and was sold in early 2011.
- The retail chain tíu-ellefu (10-11), which operates 23 grocery stores in the Reykjavík area, was split from Hagar with the aim of selling it separately. Preparations for the sale began in 2010 and the sale is expected to be completed in early 2011.

# 2010 in brief cont. (2)



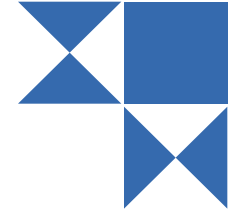
Following the new strategic vision for the Bank organizational changes were made – continued focus on operational efficiency

## *Operations and restructuring*

- Following the new strategic direction and with new management joining the Bank substantial changes were made to the organizational structure of the Bank.
- The Human Resources, Back Office and IT divisions were merged into a single division, Operations.
- The Treasury and Capital Markets division was split and Treasury became a part of the Finance department and Capital Markets joined forces with Corporate Banking.
- Organizational changes within Retail Banking
- The Bank will continue to focus on operational efficiencies as well as efficiencies within the Icelandic banking sector.



# 2010 in brief cont. (3)



Solid performance in a turbulent environment with net earnings of ISK12.6 billion

## *Comprehensive Income*

- Net earnings of ISK 12.6 billion in 2010 compared with ISK 12.9 in 2009
- Net interest income of ISK 19.8 bn. in 2010 compared with ISK 12.2 bn. in 2009
  - Net interest margin was 2.8% in 2010 compared with 1.9% in 2009
- Net commission income was ISK 6.9 bn. in 2010 compared with ISK 5.9 bn. in 2009
  - Acquisition of Valitor had a significant impact
- Net financial income was ISK 1.4 bn. in 2010 compared with ISK 10.4 bn. in 2009
  - Volatility of the ISK
  - Fair value loss of the Drómi bond
- Expenses were in line with estimates
- ROE was 13.4% in 2010 compared with 16.7% in 2009

## *Financial Position*

- Balance Sheet contracted slightly and was ISK 813 bn. at the end of 2010 compared with ISK 838 bn. on 8 January 2010 and ISK 757 bn. at year end 2009
  - Deposits decreased by ISK 56 bn. from 31.12.2009
  - Appreciating ISK lowered value of foreign deposits and assets
- Deposit funding ratios improved and are now in line with competition
  - Diversification of funding sources continues to be a priority
- Capital adequacy ratio was 19.0% at year end 2010 compared with 16.4% on 8 January 2010 and 13.7% at year end 2009

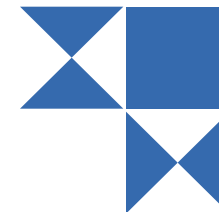




## *Statement of Comprehensive Income*



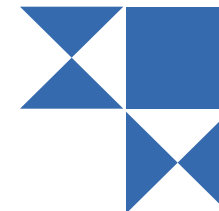
# Consolidated Statement of Comprehensive Income



- Operating income amounted to ISK 35.6 bn. in 2010 compared with ISK 31.9 bn. in 2009
  - Increased by 11.8% between years
- Salaries and other operating expenses amounted to ISK 18.3 bn. in 2010 compared with 15.3 bn. in 2009
  - Increased by 19.2% between years
- Net earnings amounted to ISK 12.6 bn. in 2010 compared with ISK 12.9 bn. in 2009
  - Decreased by 2.4% between years

Income statement - consolidated		
Million ISK	2010	2009
Net interest income	19.785	12.188
Net change in valuation on loans and receivables	1.878	-296
Net interest income less val.on loans and receiv.	21.663	11.892
Net commission income	6.866	5.862
Net financial income	1.361	10.353
Other operating income	5.733	3.758
<b>Operating income</b>	<b>35.623</b>	<b>31.865</b>
Salaries and related cost	-9.272	-8.073
Other operating expenses	-9.020	-7.273
<b>Net earnings before taxes</b>	<b>17.331</b>	<b>16.519</b>
Income tax	-3.481	-2.568
Bank Levy	-290	0
Net earnings from discl.operations net of tax	-1.002	-1.080
<b>Net earnings</b>	<b>12.558</b>	<b>12.871</b>

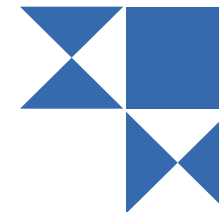
# Net interest income



- Net interest income in 2010 was ISK 19.8 bn., compared with ISK 12.1 bn. in 2009, increase by 62.3%
  - The Central Bank's base rate decreased from 8.5% to 3.5% during the year
    - Interest income on loans and receivables decreased less than interest expense on deposits during 2010
  - Recent FME ruling that the interest margin on the Drómi Bond should decrease by 175 bps, effective from 1 July 2010
    - Decrease in net interest income by ISK 740 million in Q4 2010 – thereof ISK 370 million correction from Q3 2010
  - The Bank was long inflation ISK 18.7 bn. on 31 December 2010, compared with a short position of ISK 14.7 bn. on 31 December 2009
    - Inflation during the year was 2.6%

Net interest income		
Million ISK	<b>2010</b>	<b>2009</b>
Cash and balances with central bank	937	2.793
Loans and receivables	38.004	45.408
Securities	11.320	10.934
Compensation instrument	1.256	2.411
Other	851	5.359
<b>Total interest income</b>	<b>52.368</b>	<b>66.905</b>
Deposits	28.222	53.060
Borrowings	2.683	1.564
Subordinated loans	1.250	0
Securities	0	17
Other	428	76
<b>Total interest expenses</b>	<b>32.583</b>	<b>54.717</b>
<b>Total net interest income</b>	<b>19.785</b>	<b>12.188</b>

# Change in valuation on loans and receivables

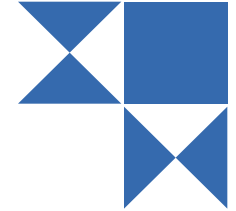


- Total valuation change in 2010 was ISK 1.9 bn. compared with -296 million in 2009
- Big volatility in valuation of loans
  - Increase in value of ISK 40 bn. mainly due to better financial performance of exporting companies
  - Additional impairment of ISK 27 bn. mainly related to real estate companies, local services and saving banks
    - Loss of ISK 2.7 bn. from SPOL and AFL related to FX ruling
- 80% of net increase in value of Ring-fenced assets belongs to Resolution committee, or ISK 9.6 bn. for the year 2010

Change in valuation on loans and receivables		
Million ISK	2010	2009
Increase in value of loans and receivables *	40.269	20.199
Impairment on loans and receivables **	-26.787	-9.939
Changes in compensation instrument ***	-11.604	-10.556
<b>Total change in valuation on loans and receivables</b>	<b>1.878</b>	<b>-296</b>
<b>* Increase in value of loans and receivables</b>	<b>2010</b>	<b>2009</b>
Increase in value of ring-fenced assets	27.535	17.827
Increase in value of loans to fin.institut.	0	2.127
Increase in other loans	12.734	245
<b>Total increase in value of loans and receivables</b>	<b>40.269</b>	<b>20.199</b>
<b>** Impairment on loans and rec. to cust.</b>	<b>2010</b>	<b>2009</b>
Ring fenced loans	13.030	4.632
Other loans	11.065	4.351
From subsidiaries (AFL - SPÓL)	2.692	956
<b>Total impairment on loans and receiv. to cust.</b>	<b>26.787</b>	<b>9.939</b>
<b>*** Change in comp. instrument - calculation</b>	<b>2010</b>	<b>2009</b>
Increase in valuation of assets	27.535	17.827
Impairment on loans	-13.030	-4.632
Impairment from discontinued operation	-2.521	0
<b>Total change on ring-fenced assets</b>	<b>11.984</b>	<b>13.195</b>
Kaupthing share 80%	9.587	10.556
<b>Arion bank share 20%</b>	<b>2.397</b>	<b>2.639</b>



# Net financial income



Decreasing net financial income due to volatility of the ISK and FV changes

- Total net financial income amounted to ISK 1.4 bn. in 2010 compared with ISK 10.4 bn. in 2009, a 86.9% decrease between years
  - During 2010 the exchange rate of the ISK appreciated by 10.6% (average) compared with depreciation by 7.4% (average) in 2009
  - The Bank had ISK 48.6 bn. in net real long foreign currency status on 31 December 2010, compared with ISK 49.6 bn. at year end 2009
    - FX sales before year end
    - Reclassification of FX/ISK loans
  - FV change of Drómi loss of ISK 3.5 bn. is a result of FME ruling in February 2011

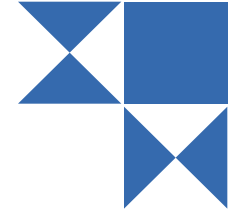
Net financial income		
Million ISK	<b>2010</b>	<b>2009</b>
Dividend income	34	29
Net gain (loss) on fin.ass. and liab. Cl. as HFT*	-531	1.240
Net gain (loss) on fin.ass. and liab. Des. at FVTPL**	899	369
Net gain (loss) on foreign exchange	4.459	8.715
Fair value change to Drómi bond	-3.500	0
<b>Total net financial income</b>	<b>1.361</b>	<b>10.353</b>

\* Net gain (loss) on financial assets and liabilities classified as held for trading.

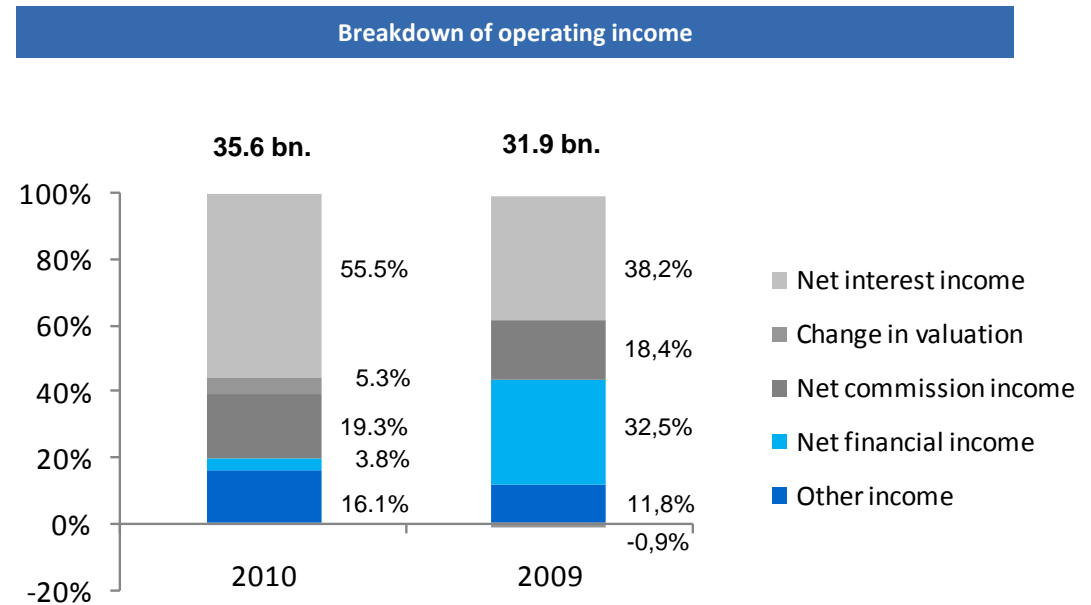
\*\* Net gain (loss) on financial assets and liabilities designated at Fair value

# Total operating income

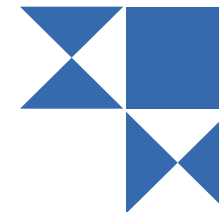
## Increased quality of operating income



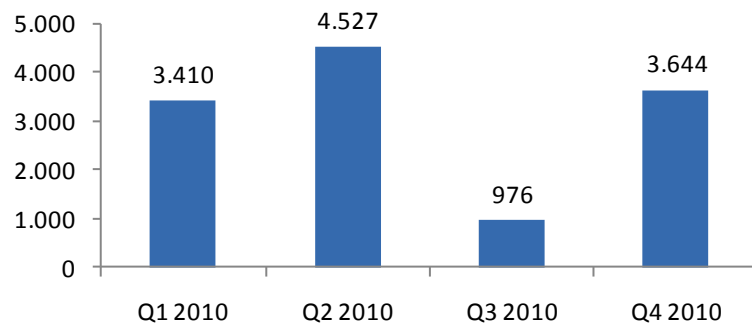
- Net interest was 55.5% of total operating income in 2010 compared with 38.2% in 2009
- Change in valuation was 5.3% of total operating income in 2010 compared with -0.9% in 2009
- Net commission income was 19.3% of total operating income compared with 18.4% in 2009



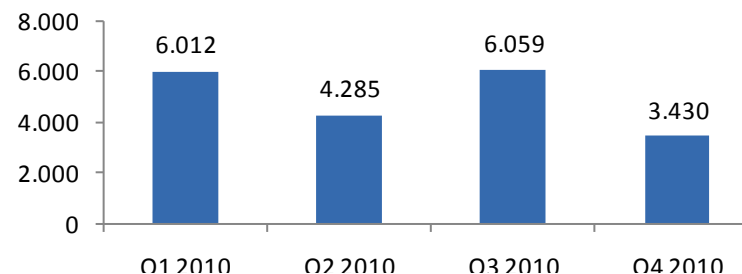
# Comparison between quarters 2010



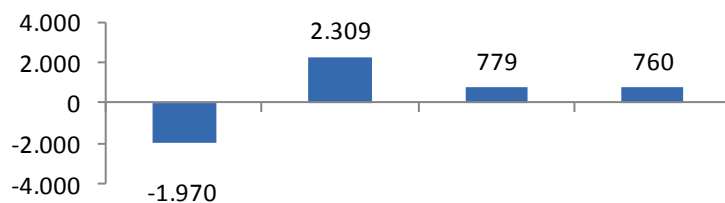
**Net earnings**



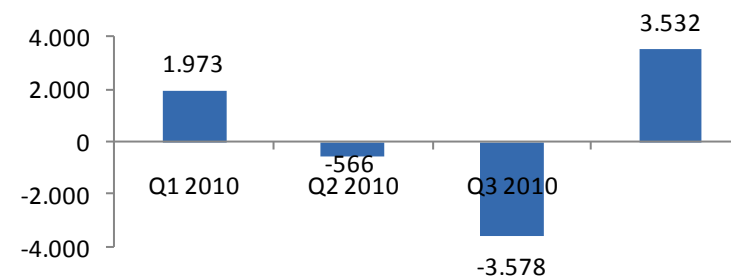
**Net interest income**



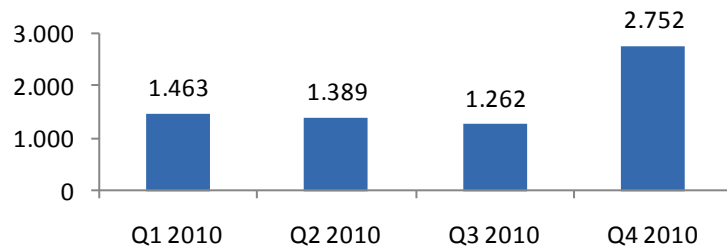
**Net change in valuation and receivables**



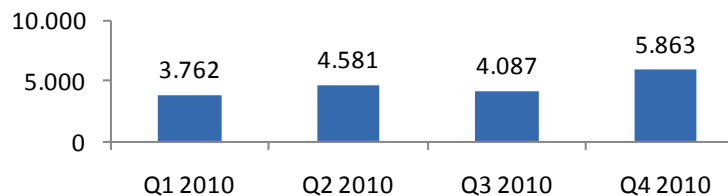
**Net financial income**



**Net commission income**

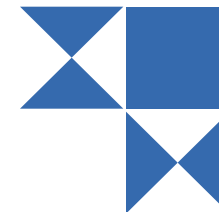


**Total OPEX**





# Effect of sale of HFS subsidiaries on P&L and Balance Sheet



2010	Income Statement	Effect of HFS subsid*	Net of subsid*
Million ISK			
Net interest income	19.785	2.822	22.607
Changes on loans and receivables	1.878		1.878
Net fee and commission income	6.866		6.866
Net financial income	1.361		1.361
Other operating income	5.733		5.733
<b>Operating income</b>	<b>35.623</b>	<b>2.822</b>	<b>38.445</b>
Salaries and related expenses	-9.272		-9.272
Administration expense	-8.297		-8.297
Other operating expense	-723		-723
<b>Earnings before income tax</b>	<b>17.331</b>	<b>2.822</b>	<b>20.153</b>
Income tax and Bank Levy	-3.771	-508	-4.279
<b>Earnings from continuon operation</b>	<b>13.560</b>	<b>2.314</b>	<b>15.874</b>
Net loss from disc. operation	-1.003	-1.598	-2.601
<b>Earnings from continuon operation</b>	<b>12.557</b>	<b>716</b>	<b>13.273</b>

31.12.2010	Balance Sheet	Effect of HFS subsid*	Net of subsid*
Million ISK			
Cash and balances with central bank	30.628		30.628
Loans to credit institutions	67.846		67.846
Loans to customers	451.219	20.772	471.991
Financial assets	134.767		134.767
Compensation instrument	24.188		24.188
Intangible assets	4.352		4.352
Investments in associates	2.713		2.713
Other assets	96.902	-41.924	54.978
<b>Total assets</b>	<b>812.615</b>	<b>-21.152</b>	<b>791.463</b>
Loans from cred. inst. and central bank	95.646		95.646
Deposits	457.881		457.881
Borrowings	65.278		65.278
Subordinated loans	26.257		26.257
Other liabilities	58.017	-21.152	36.865
Equity	109.536		109.536
<b>Total liabilities and equity</b>	<b>812.615</b>	<b>-21.152</b>	<b>791.463</b>

\* Hold for sale companies

- Based on sale of these HFS subsidiaries at book value.

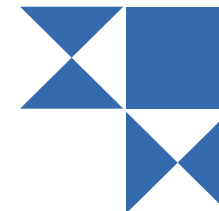
- Straight effect on CAD would be an increase from 19.0% to 19.7%.



## *Statement of Financial Position*



# Consolidated Statement of Financial Position

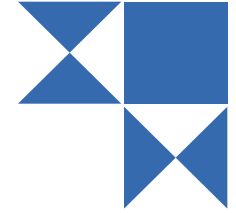


- The Bank's total assets were ISK 813 bn. on 31 December 2010, compared with ISK 838 on 8 January 2010, decrease by 3%
  - Deposits were ISK 554 bn. on 31 December 2010, compared with ISK 595 bn. on 8 January 2010, decrease 5%
  - During the year the exchange rate of the ISK appreciated resulting in lower value on assets and liabilities in foreign currencies
  - Interest bearing assets were approx. ISK 715 bn. on 31 December 2010 and interest bearing liabilities ISK 680 bn. On 31 December 2009 interest bearing assets were ISK 657 bn. and interest bearing liabilities ISK 636 bn.

Consolidated Statement of Financial Position			
Million ISK	31.12.2010	8.1.2010	31.12.2009
Cash and balances with central bank	30.628	41.906	41.906
Loans to credit institutions	67.846	38.470	38.470
Loans to customers	451.219	470.558	357.734
Financial assets	134.767	150.207	182.802
Compensation instrument	24.188	34.371	34.371
Intangible assets	4.352	3.512	3.512
Investments in associates	2.713	5.985	5.985
Other assets	96.902	92.564	92.564
<b>Total assets</b>	<b>812.615</b>	<b>837.573</b>	<b>757.344</b>
Deposits from cred. inst. and CB	95.646	99.219	113.647
Deposits	457.881	495.465	495.465
Borrowings	65.278	72.294	11.042
Subordinated loans	26.257	29.543	0
Other liabilities	58.023	47.156	47.156
Equity	109.530	93.896	90.034
<b>Total liabilities and equity</b>	<b>812.615</b>	<b>837.573</b>	<b>757.344</b>



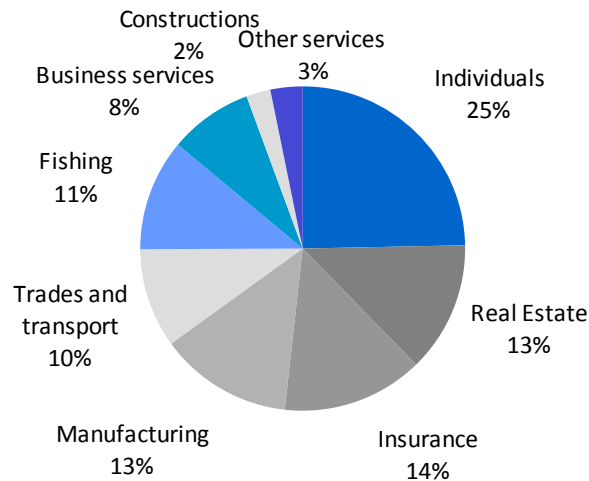
# Loans and receivables to customers



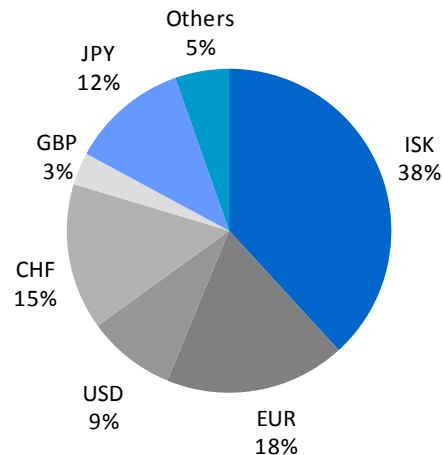
ISK portion at year end decreasing with reclassification of FX/ISK loans

- The Bank's total loans to customers were ISK 451 bn. on 31 December 2010, compared with ISK 471 bn. on 8 January 2010, decrease by 4.1%. Total loans to customers on 31 December 2009 were ISK 358 bn.
- If the impact of FX/ISK loans is taken into account, 66% of the loans to customers are effectively in ISK

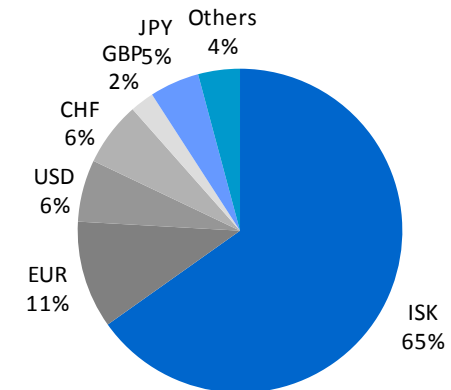
Sectors split – 31.12.2010



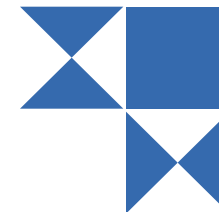
Currency split without FX/ISK impact- 31.12.2010



Currency split with FX/ISK impact - 31.12.2010



# Financial assets

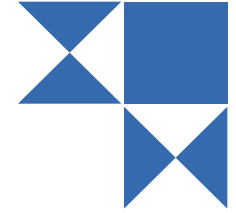


- The Bank's financial assets were ISK 135 bn. on 31 December 2010 compared with ISK 150 bn. on 8 January 2010, a decrease of 10.3%
  - The Drómi bond and the Government bonds are the bank's two largest financial assets or 82.5% of total financial assets on 31 December 2010 (was 87.1% on 8 January 2010)
  - Sale of SPRON assets during the year decreased the Drómi bond by 20.8%

Financial assets			
Million ISK	31.12.2010	8.01.2010	31.12.2009
Government bond	38.223	38.661	71.256
Other government bonds	7.021	4.472	4.472
Drómi bond	73.017	92.209	92.209
Other bonds and debt instruments	1.851	5.546	5.546
Securities used for hedging	3.213	2.236	2.236
Shares and equity inst. with var.inc.*	10.316	7.078	7.078
Derivatives	1.126	6	6
<b>Total financial assets</b>	<b>134.767</b>	<b>150.207</b>	<b>182.802</b>

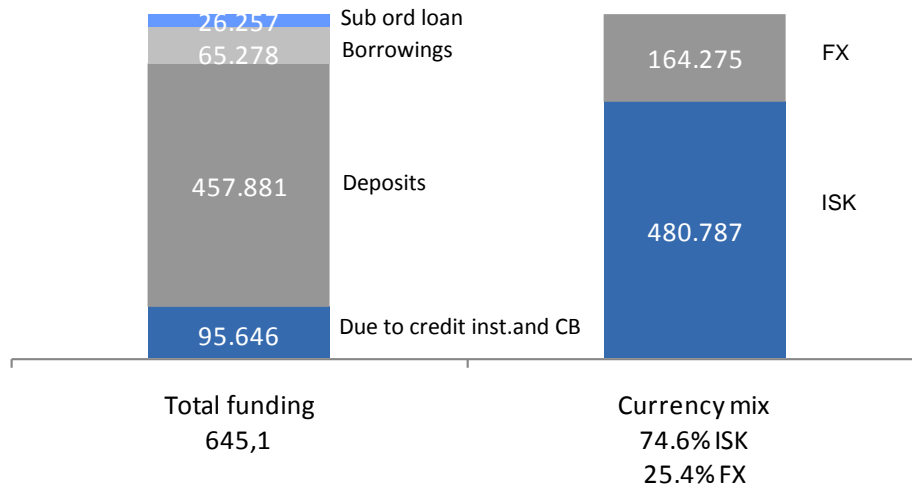
\*Shares and equity instruments with variable income

# Total funding

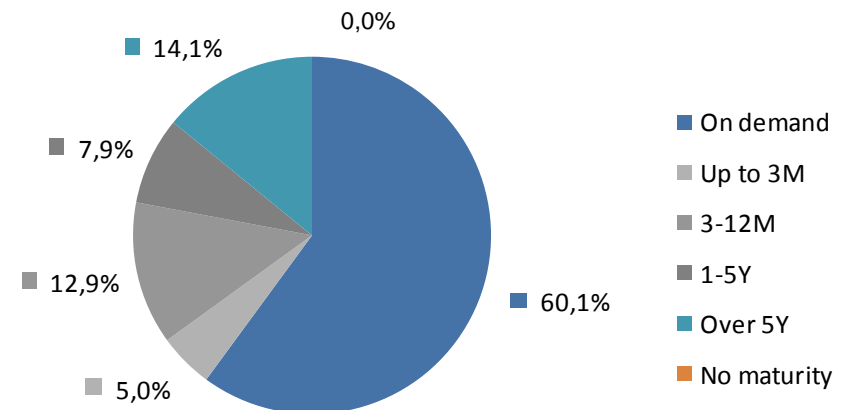


- The Bank's total funding was ISK 645 bn. on 31 December 2010 compared with ISK 697 bn. on 8 January 2010, decrease by 7.5%
  - Funding was mostly denominated in ISK or 74.6%
  - 60.1% of the total funding was on demand
  - Diversification of funding sources a priority

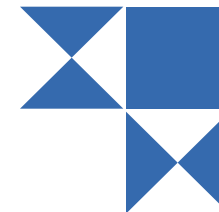
Combination of total funding 31.12.2010



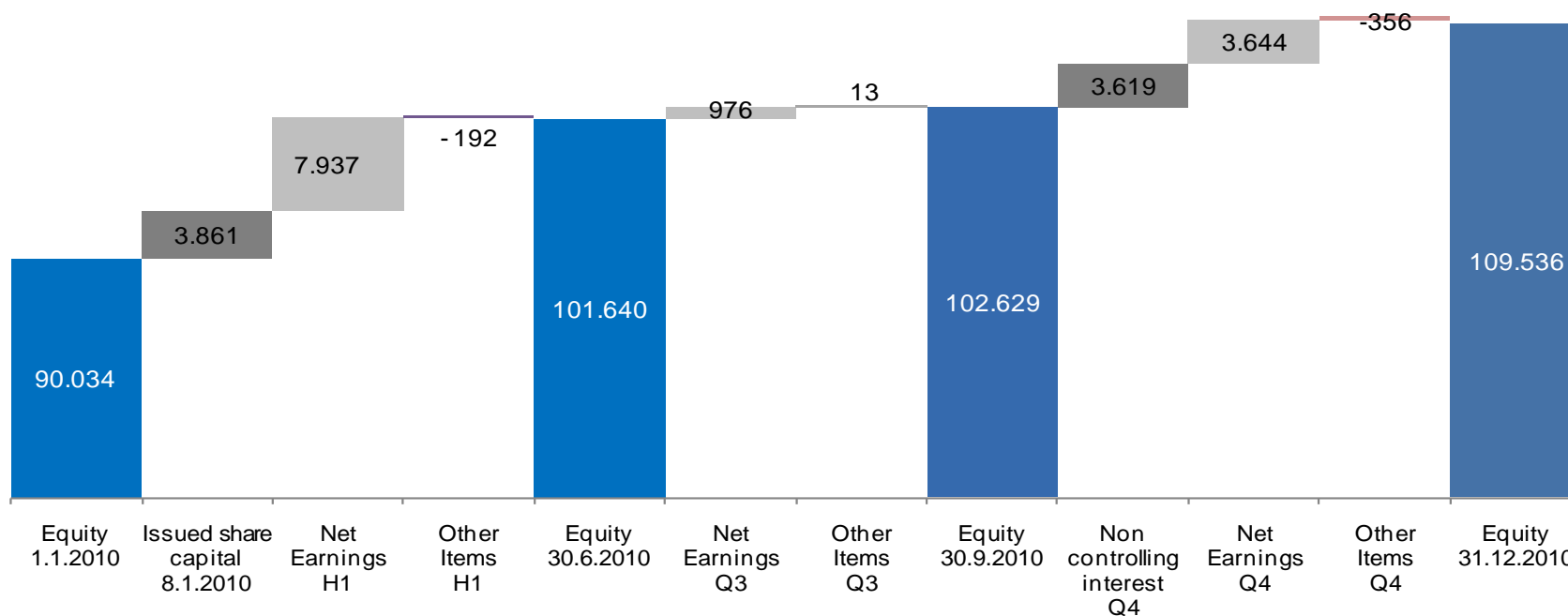
Breakdown by maturity of total funding - 31.12.2010



# Equity



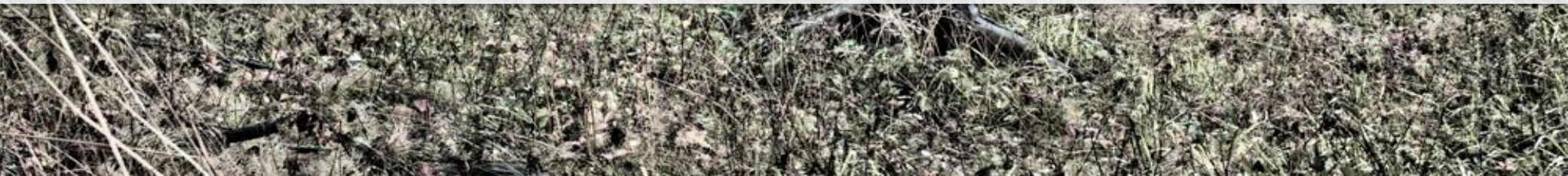
- The Bank's total equity was ISK 110 bn. on 31 December 2010 compared with ISK 94 bn. on 8 January 2010, increase by 16.7%
  - Increase in non-controlling interest in Q4 2010 are due to acquisition of Valitor





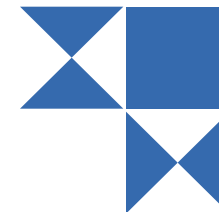


*Key Ratios*





# Key risk indicators



The Bank is exceeding the main risk requirements set by FME

- The capital adequacy ratio for 31 December 2010 was 19.0%, compared with 16.4% on 8 January 2010. The ratio was 13.7% on 31 December 2009
  - The FME requirement is 16%
- The secured liquidity risk ratio for 31 December 2010 was 24.8%, compared with 26.6% on 8 January 2010. The ratio was 22.8% on 31 December 2009
  - The FME requirement is 20%
- The cash ratio for 31 December 2010 was 11.2%, compared with 8.7 on 8 January 2010. The ratio was 8.1% on 31 December 2009
  - The FME requirement is 5%

## Risk weighted assets

Million ISK	31.12.2010	8.01.2010	31.12.2009
Credit Risk	513.328	574.943	480.374
Market Risk FX	97.657	94.366	89.233
Market Risk Other	20.397	14.844	14.849
Operational Risk	57.267	51.055	51.055
<b>Risk weighted assets</b>	<b>688.649</b>	<b>735.208</b>	<b>635.511</b>

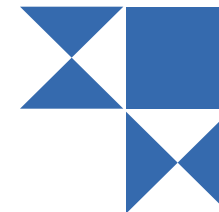
Tier 1 Capital	<b>109.536</b>	<b>93.896</b>	<b>90.034</b>
Deduction from Tier 1 capital	4.647	3.050	2.843
<b>Total Tier 1 capital</b>	<b>104.889</b>	<b>90.846</b>	<b>87.191</b>
Tier 2 Capital	26.257	29.543	0
<b>Total capital base</b>	<b>131.146</b>	<b>120.389</b>	<b>87.191</b>

<b>CAD ratio</b>	<b>19,0%</b>	<b>16,4%</b>	<b>13,7%</b>
<b>T1 ratio</b>	<b>15,2%</b>	<b>12,4%</b>	<b>13,7%</b>

Liquidity risk	31.12.2010	08.01.2010	31.12.2009
Secured liquidity risk	24,8%	26,6%	22,8%
Cash ratio	11,2%	8,7%	8,1%

# Key performance indicators

The Bank is reaching the short-term target of 12.5% ROE



Key performance indicators		
	2010	2009
Return on equity (ROE)	13,4%	16,7%
Return on assets (ROA)	1,5%	1,9%
Net interest margin	2,8%	1,9%
Cost-to-Income ratio	54,2%	47,7%
Cost-to-Total assets ratio	2,3%	2,0%
Effective tax rate	20,1%	15,5%
Loans-to-deposits ratio	98,5%	72,2%
RORWA	1,8%	2,0%
Risk weighted assets / Total assets	84,7%	83,9%
AVG employees	1.201	1.177
Employees at the end of the year	1.260	1.157
Operating income pr. avg employee	30	27
Operating cost pr. avg employees	15	13

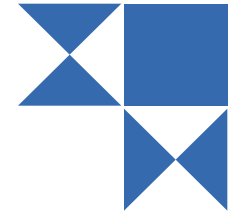


*Supreme Court ruling of February 14, 2011*



# Effect of new Supreme court ruling

Continued uncertainty that is likely to prolong SME recovery



## *Loan Category F*

- In the summer of 2010 the Bank participated in an FME survey of the impact of FX loans being found illegal
- In the survey FX-loans whose principal is somehow specified in ISK, and were disbursed and repaid with ISK were classified as loan category F
  - Recent court judgments have increased the uncertainty about the legitimacy of type F loans

## *Arion Bank's Capital Ratio*

- The recalculation of FX mortgages to individuals due to the December 2010 legislation has resulted in a 4.5 bn ISK loss in book value for those loans
  - Improved recovery for other loans to individuals transferred on a portfolio basis has compensated for this loss in annual accounts
  - At end 2010 the CAD is at 19.0%, after accounting for the legislation
- Should all remaining F type loans be judged illegal, the loss in book value should not exceed ISK 10 bn.
  - The Bank predicts that the capital ratio would remain above 16%, perhaps as high as 17.5%
- The rest of Arion Bank's foreign currency loan-book is widely regarded not to be at risk

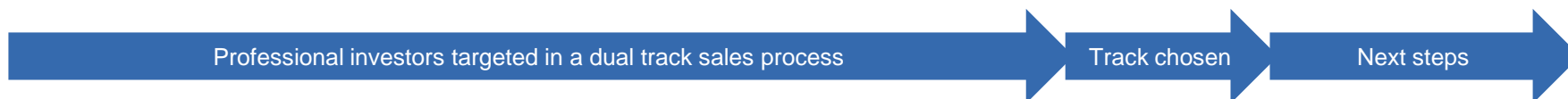
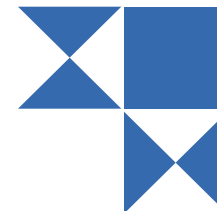


*The sales process of Hagar*



# Hagar hf. – sales process

Dual track sales process of the Bank's 95.7% share (99.5% of outstanding shares)



In October the Bank announced its plans to sell a core holding in Hagar in an open sales process, stating that it would consider all offers made for its holding in the company.

## Pre IPO - Target allocation 15-29%

- In order to attract investors who could play a key role in Hagar's affairs and to establish the core holding in the company along with price setting mechanism for the book building stage
- Indicative offers received 15 November 2010
- Binding offers received 28 January 2011 → Negotiation with the bidder which made the best offer

### Conclusion:

- **Core stake acquired by Búvellir slhf, a company owned by a diverse group of pension funds and other Icelandic professional investors of which some are managed by Stefmir (the Bank's AM company)**
- **34% sold at ISK 10 per share along with 10% call option at ISK 11 per share**
- **Acquisition price ISK 4,140 million, and thus enterprise value is approximately ISK 24 billion as net interest-bearing debts were ISK 12.5 billion 30 November 2010**

## Trade sale explored

- Increase likelihood of full exit for the bank in 2011
- May capture full (synergistic) value without an IPO discount
- Capitalize on investor's interest in acquiring the whole company
- **Satisfactory offers received before 28 January 2011, along with requests for exclusive negotiation**

## IPO and listing

### Book building

- Target allocation 20-35%
- Price range derived from pre IPO

### Retail offering

- Target allocation 5-10%
- Shares at book building price
- Process parallel to final stages of book building

### Listing

- Nasdaq OMX Iceland
- Application intended in 2011
- The Bank's remaining share 19-29%



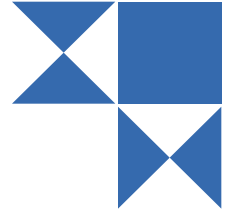




*Thank you*



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