Consolidated Financial Statements 2020

Contents

Arion Bank in brief
2020

6.5%
Return on equity

48.1%
Cost-to-income

27.0%
Capital adequacy ratio

Rating from S&P
Long term: BBB
Short term: A-2
Outlook: Stable

FINANCE
UNEP INITIATIVE

Equal Pay Certification

PRI Principles for Responsible Investment

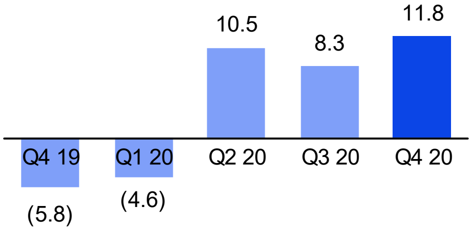
Arion Bank

- Arion Bank and subsidiaries form a group which focuses on developing long-term relationships with its clients and is a market leader as a provider of cutting-edge and modern banking services
- The Bank's strategy is to excel by offering smart and reliable financial solutions which create future value for our customers, shareholders and society as a whole
- The diverse service offering at Arion Bank means that the revenue base is broad and the loan portfolio is well diversified between retail and corporate customers. The high percentage of mortgages and the healthy distribution of loans across different sectors reduces credit risk
- The Bank is a market leader in digital solutions and innovation. Numerous new digital solutions have been launched in the past few years, enhancing service to customers and making the Bank's operations more efficient, which in the long term reduces operating expenses across the Bank
- The Bank's structure has been simplified and the branch network and business premises have been streamlined
- Arion Bank has significant excess capital and aims to pay approximately ISK 50 billion in dividends and/or share buy-backs over the next few years

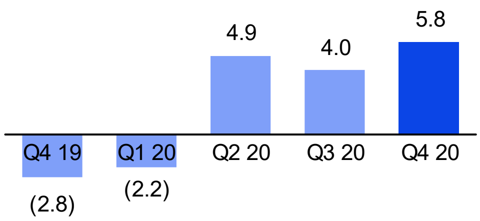
Key figures
(ISK million)

	2020	2019
Net earnings	12,469	1,100
ROE	6.5%	0.6%
ROE continuing operations	8.8%	7.2%
Net interest margin	2.9%	2.8%
Cost to income ratio	48.1%	56.0%
Operating income / REA	7.0%	6.4%
	31.12.2020	**31.12.2019**
Total assets	1,172,706	1,081,855
Loans to customers	822,941	773,955
Deposits	568,424	492,916
Borrowings	298,947	304,745
Stage 3 gross	2.6%	2.7%
Leverage ratio	15.1%	14.1%
Number of employees	776	801
EUR/ISK	156.09	135.83

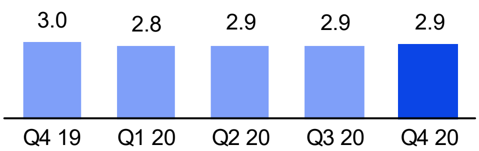
Return on equity (%)



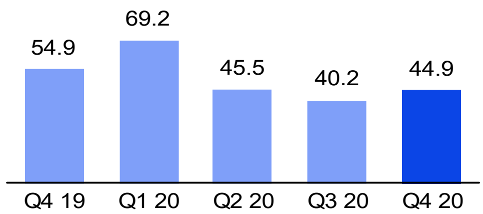
Net earnings (ISK billion)



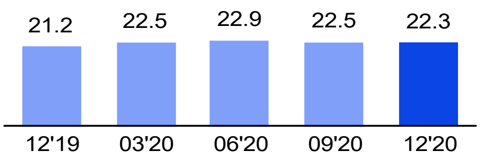
Net interest margin (%)



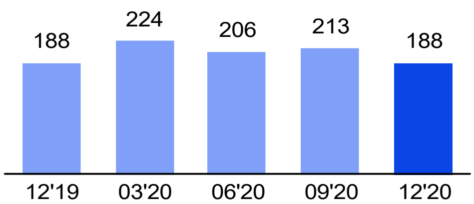
Cost-to-income ratio (%)



CET 1 ratio (%)



LCR ratio (%)



Endorsement and statement
by the Board of Directors and the CEO

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2020 include the Consolidated Financial Statements of Arion Bank ("the Bank") and its subsidiaries, together referred to as "the Group".

About Arion Bank

Arion Bank places great importance on developing long-term relationships with its clients and is a market leader as a provider of cutting-edge and modern banking services. The Bank is listed on the main lists of Nasdaq Iceland and Nasdaq Stockholm.

The Bank’s strategy is to excel by offering smart and reliable financial solutions which create future value for our customers, shareholders and society as a whole. The Bank’s updated strategy was approved at a meeting of the Board of Directors in December 2020 after extensive revision by the Board of Directors and the management.

Arion Bank provides services to households, corporates and investors in three business segments: Retail Banking, Corporate & Investment Banking, and Markets. The service offering is further augmented by the subsidiaries Stefnir and Vörður. Stefnir is one of the largest fund management companies in Iceland, and Vörður is the fastest growing insurance company in Iceland, providing non-life and life insurance. The diverse service offering at Arion Bank means that the revenue base is broad and the loan portfolio is well diversified between retail and corporate customers. The high percentage of mortgage loans and the healthy distribution of loans across different sectors reduces credit risk.

The Bank is a market leader in terms of digital solutions and innovation. Numerous new digital solutions have been launched in the past few years, enhancing service to customers and making the Bank's operations more efficient, which in the long term reduces operating expenses across the Bank. The Bank’s structure has been simplified and the branch network and business premises have been streamlined.

Arion Bank is a financially robust bank which places great importance on operating responsibly in harmony with society and the environment. The Bank places importance on paying competitive dividends to shareholders.

Arion Bank is an Icelandic bank which operates in Iceland and also provides services to companies in the seafood and seafood related sectors in Europe and North America.

Operations during the year

Earnings from continuing operations amounted to ISK 16,747 million in 2020 and return on equity from continuing operations was 8.8%. Net earnings amounted to ISK 12,469 million and return on equity was 6.5%. Total equity at the end of December amounted to ISK 197,845 million. The Group's capital ratio, as calculated under the Financial Undertakings Act No. 161/2002, was 27.0% at year-end and the CET1 ratio was 22.3%, assuming ISK 3 billion dividend payment and ISK 15 billion buy back of own shares, which has received permission from the Financial Supervisory Authority of the Central Bank of Iceland (FSA). These ratios comfortably exceed the requirements made by the FSA and Icelandic law. The liquidity position was also strong at year-end and well above the regulatory minimum.

The Group’s Balance sheet increased by 8% during the year or by ISK 91 billion, whereas the risk-weighted exposure amount (REA) increased by ISK 26 billion or 3.6%. The increase is mainly due to a 6.3% increase in loans to customers, approximately ISK 50 billion, and an increase in the liquidity position due to deposit growth and proceeds from the Bank’s issuance of AT1.

The Bank performed above expectations during the year following extensive organizational changes which came into effect in late 2019, particularly given the circumstances. The Bank was swift to respond when Covid-19 took hold in March and enabled its employees to work from home. Approximately 80% of employees have worked at home more or less since then. The Bank also closed its branches to regular visits. Despite this inconvenience it did not disrupt the Bank’s services to customers and digital solutions were put to excellent use in these circumstances. Mortgage lending volumes were at an all-time high and the Bank continued to build on its strong relationships with its corporate customers and institutional investors.

When the pandemic took hold the Bank decided to give retail customers the option of deferring payments of instalments and interest on their mortgages. Many borrowers took advantage of this option in the beginning but far fewer chose to extend the payment holiday, which is an excellent indication of the good financial standing of these borrowers. The Bank also participated in the government measures on corporate loans with good results.

The early days of the global pandemic were wracked with uncertainty over the economy and the need for loan impairments in the banking system. Arion Bank took a prudent approach and impairments were substantial in the first quarter. Impairments have declined as the year has passed and a clearer picture of the consequences of the pandemic has emerged. Impairments at Arion Bank were comparable to those at the major Nordic banks and it is evident that the Bank has the financial strength to deal with the consequences of the pandemic. It will become much clearer this year what the actual losses on the Bank’s loan portfolio due to the economic downturn will be.

Assets held for sale and discontinued operations

The operating results of the subsidiaries Valitor hf., Stakksberg ehf. and Sólbjarg ehf. are presented as discontinued operations as they are all classified as held for sale.

Valitor hf. is a market leader in Iceland in acquiring services and payment solutions and also operates in the United Kingdom. During the year Valitor underwent extensive organizational changes and streamlining measures and sold off its business in Denmark and some of its UK operation. These measures have already yielded positive results. The operating results of Valitor nevertheless had a negative effect of ISK 1.3 billion on the consolidated financial results of Arion Bank in 2020. The sale process of Valitor continues but is taking longer than originally expected, partly due to the changing market conditions related to Covid-19. Despite this delay the Bank is seeing interest from various investors in Valitor. At year-end the net book value of Valitor was ISK 8.5 billion.

Endorsement and statement
by the Board of Directors and the CEO

Stakksberg ehf. manages all the assets of the silicon plant in Helguvík. Stakksberg has been working to reduce uncertainty regarding the recommissioning of the plant, but the sale of the company has fallen behind the original schedule for a number of external reasons. Stakksberg had a negative impact of ISK 1.4 billion in 2020 due to the impairment of the silicon plant. At year-end the book value of Stakksberg was ISK 1.6 billion which broadly reflects the value of the plot of land and the re-sale value of the machinery.

Sólbjarg ehf. administers the Bank's shareholding in travel companies in Scandinavia and Iceland which previously belonged to TravelCo. The business has been undergoing restructuring during the year as the travel industry has been hit hard by the global pandemic. As part of the restructuring process units have been sold off, both in Iceland and abroad. Sólbjarg had a negative impact of ISK 1.6 billion in 2020 and the main reason for this is the impairment of the company's underlying assets. At year-end the net book value of Sólbjarg was ISK 0.7 billion.

Economic outlook

According to preliminary figures from Statistics Iceland, GDP shrank by 10.4% between years during the third quarter of 2020, which is in line with forecasts. Given the importance of the travel sector to the economy, it was fully expected that the economic downturn would be significant in an international context, as turned out to be the case. Despite the relaxation of public health measures over the summer, the tourist high season was just a shadow of itself, with tourist numbers dropping 82% between years and general unemployment continuing to rise. Household demand remained buoyant and domestic payment card turnover hit record heights in July. Card turnover in the fourth quarter of last year indicates that Icelandic households are generally on a firm footing and that private consumption will be far more resilient than generally expected. Although vaccination programmes have begun in Iceland and abroad, it's hard to predict when the travel sector will rebound and when the economy will recover. Domestic analysts forecast 3% GDP growth on average this year and stronger growth next year. The general outlook is reflected in the difficult situation on the labour market and unemployment, currently 12.1%, is expected to continue to grow in the coming months before eventually starting to drop. Inflation has risen 4.3% on the back of a weakening króna but the inflation spike is expected to be short-lived. It is important that inflation expectations have been securely anchored and enabled the Central Bank's monetary policy committee to wield its interest rate tool properly and to support the economy with low interest rates. Although the economy has yet to get moving, it is helped by the fact that its foundations are robust and extensive countermeasures by the government and the Central Bank have alleviated the impact.

Outlook for the Bank

Uncertainty surrounding the global pandemic has been reduced by the emergence of a vaccine and the roll-out of vaccination programmes. The economy is expected to bounce back in the second half of 2021 and the Bank is well equipped to work with its retail and corporate customers. Following the successful organizational changes from just over a year ago, the Bank has just updated its strategy and has a clear vision for the future. The Bank is highly capitalized, has strong liquidity in both Icelandic krónur and foreign currencies and is well prepared to meet the diverse needs of its customers. Mortgage lending is expected to continue to grow, whereas corporate lending growth is projected to be slower, as the Bank's objective is to work with customers and find solutions which meet their needs, whether through borrowing or different types of market funding. This is in line with the Bank's objective to make effective use of risk-weighted assets while at the same time growing the business. Rationalization measures can be expected across the business sector in the medium term. The Bank will take an active part in working on mergers and acquisitions and other streamlining measures as it has the ability to tackle complex corporate projects. The Bank also intends to strengthen its position in asset management and capital markets.

Increased efficiency is a goal shared by all European banks and Arion Bank is no exception. The Bank will continue to seek ways to rationalize its business through technology and digital channels.

Funding is and will be an important component of the Bank's activities. Growing deposits and wholesale funding on the domestic and international markets remain key tasks. The Bank has completed the optimization of its capital structure composition with the issuance of Tier 2 and additional Tier 1 bonds in line with strategy. The Bank aims to distribute capital to shareholders in accordance with stated objectives and it could even hold a reverse tender offering of own shares if the conditions are right, and/or pay additional dividends. A stronger performing business and the Bank's acquisition of own shares, at a price below book value of equity, result in increased shareholder value going forward.

Employees

The Group had 776 full-time equivalent positions at the end of the year compared with 801 at the end of 2019. A total of 648 of these positions were at Arion Bank, compared with 687 at the end of 2019.

In December the Board of Directors approved a revised bonus scheme which comes into effect in 2021. The scheme is in compliance with the FSA's rules on bonus payments to employees of financial institutions. The scheme is basically split into two parts. Firstly, employees can receive up to 10% of their fixed salary for 2021 in the form of a cash bonus payment. Secondly, a limited group can receive up to 25% of their fixed salary as a bonus in the form of shares in the Bank which will be subject to three-year lock-up period. The criterion used to determine whether a bonus will be paid for 2021, in part or in full, is whether the Bank's return on equity in 2021 is higher than the weighted ROE of the Bank's main competitors. The Board of Directors also approved a new share option plan for all employees of the Bank, which is important for aligning the interests of employees with the long-term interests of the Bank. The share option plan is for five years and employees are entitled to buy shares for up to ISK 600,000 each year. The purchase price is determined by the Bank's average share price 10 days before the share option agreement was signed, which was 3 February 2021.

Funding and liquidity

In terms of funding and liquidity management the year was characterized by the Bank's strong liquidity position and strong deposit growth. The Bank's liquidity position was well above the regulatory minimum of 100% all year, with a liquidity coverage ratio of 188% at the end of 2020. The strong liquidity position is due to deposit growth, increasing 15% from ISK 493 billion to ISK 568 billion, while lending growth was moderate. The Bank did not have significant bond or long-term funding maturities in 2020. The €300 million bond maturing in June 2020 had mostly been repurchased in a tender offer at the end of 2019. At the end of 2020 the Bank also refinanced €300 million of the €500 million issue maturing in December 2021, thereby ensuring that its medium-term refinancing needs remain moderate and liquidity risk is minimized.

In the first part of 2020 Arion Bank continued to issue covered bonds which are secured in accordance with the Covered Bonds Act No. 11/2008 but stopped issuing in mid-year due to its strong liquidity. The Bank issued a total of ISK 5,060 million in covered bonds.

Group ownership

The main venue at which the Board and the Bank report information to the shareholders and propose decisions is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information sensitive to the market will be released through a MAR press release. Arion Bank also arranges quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

At the end of December 2020 Taconic Capital was the largest shareholder in Arion Bank with a shareholding of 23.22%. Gildi Pension Fund was the second largest shareholder with a shareholding of 9.92%. Arion Bank owned 0.69% of its own shares at the end of 2020. On 17 March 2020 the AGM of Arion Bank resolved to cancel 84 million shares amounting to ISK 84 million of the Bank's share capital. The cancellation of own shares was carried out in May 2020. The Bank's shares were traded in high volumes during January this year and more information on Arion Bank shareholders can be found in Note 36.

Capital, risk weighted assets and dividends

Arion Bank's dividend policy states that the Bank shall pay 50% of net earnings in dividends and that additional dividends or share buybacks can be considered when the Bank's capital levels are above the minimum requirements set by the regulators in addition to the Bank's management buffer. In light of its strong capital position, Arion Bank expects to pay a dividend or buy back own shares in the amount of approximately ISK 50 billion over the next few years. The Board of Directors nevertheless is taking into consideration the statement by the Financial Supervision Committee of the Central Bank from 13 January and proposes that a dividend of ISK 2,990 million be paid following the 2021 AGM in respect of the 2020 financial year, corresponding to ISK 1.74 a share. On 8 February 2021 the Financial Supervisory Authority authorized the Bank to buy back own shares for up to ISK 15 billion. The Board of Directors has broad authority to make a proposal on dividend payments or other release of capital and therefore the Board may possibly call an extraordinary shareholders' meeting later in the year at which such proposal would be made.

The Group's capital adequacy ratio on 31 December 2020 was 27.0% and the CET 1 ratio 22.3%. Calculations of the ratio take into account the foreseeable distribution of capital amounting to ISK 18 billion, firstly in the form of a dividend of ISK 3 billion and secondly in the form of a buyback of the Bank's own shares of ISK 15 billion. The proposed distribution of capital to shareholders does not affect the Bank's ability to support its customers and the Icelandic economy.

The Bank has taken measures to reduce CET 1, including by buying back own shares. In the first quarter of 2020 the Bank bought own shares for ISK 4.4 billion at market value. On 17 March 2020 the AGM of Arion Bank agreed to cancel 84 million own shares and the Bank's share buyback programme ended the same day. Arion Bank's share capital amounts to ISK 1,730 million at nominal value after the reduction. The Board of Directors proposed that a dividend of ISK 10 billion be paid in 2020 in respect of the financial year 2019, corresponding to ISK 5.5 a share. The Bank's AGM decided, however, to defer the distribution of dividends due to the uncertainty over the Covid-19 pandemic, a decision which was in line with a recommendation made by the Central Bank of Iceland. At an extended AGM of Arion Bank on 14 May 2020 a resolution was passed that no dividend would be paid in respect of 2019 and that the year's earnings would be added to the Bank's capital.

Risk-weighted exposure amounts (REA) increased by ISK 26 billion in 2020. The increase is mainly due to the change in the treatment of the Bank's shareholding in Vördur tryggingar hf. The company is removed from the group when calculating the Group's capital in accordance with capital regulations. Previously, the Bank's holding of Vördur's equity was deducted from the Group's own funds but now it contributes instead towards risk-weighted exposure amount with a risk weight of 250%. In other respects, the net change in REA is minimal despite the fact that the loan book grew by ISK 49 billion. There are two main reasons for this. At the beginning of 2020 the implementation of the Capital Requirements Regulation (CRR) in Iceland was completed which reduced capital requirements for SMEs and this reduced REA at the Bank by ISK 13 billion. Another key factor is the fact that the Bank's mortgage portfolio has grown by ISK 68 billion while assets which tie up more capital, e.g. corporate loans and financial assets in the investment book, have decreased.

On 4 May 2020 the Ministry of Finance introduced Regulation (EU) 2017/2395. The regulation addresses transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposures treatment of certain public sector exposures. European banks have been able to utilize these transitional arrangements since 2017. Financial institutions which utilize these transitional arrangements can, in 2020, add to CET 1 the equivalent of 70% of additional impairment requirements stemming from the implementation of IFRS 9. The Bank has utilized these transitional arrangements from 30 September 2020 and the effect corresponds to 0.2% of REA.

As part of the government's economic measures in response to Covid-19, the Financial Stability Committee decided to abolish the 2% countercyclical capital buffer, thereby reducing the Group's total requirement from 20.3% to 18.4%. This measure had a limited impact on Arion Bank, however, given the strong capital position, and at the same time a recommendation was made that companies limit capital distribution. At the end of 2020 the Bank's own funds were ISK 66 billion higher than the total capital requirement, factoring in the planned reduction in capital of ISK 18 billion. Excess capital, based on the Bank's objective of maintaining 17% CET 1, is ISK 40 billion in addition to the proposed distribution of capital.

Risk management

The Group faces various risks arising from its day-to-day operations as a financial institution. 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 manage and price risk factors is critical to the Group's continuing profitability as well as ensuring that the Group's exposure to risk remains within acceptable levels. The Board of Directors is ultimately responsible for the Bank's risk management framework and ensuring that satisfactory risk policies and governance structure for controlling the Bank's risk exposure are in place. The Group's risk management, its structure and main risk factors are described in the notes and in the Bank's unaudited Pillar 3 Risk Disclosures.

Governance

At the AGM on 17 March 2020, seven members were elected to serve on the Board of Directors until the next AGM, four males and three females. In addition, three Alternate Directors (two men and one woman) were elected, and they attend meetings of the Board of Directors in the event that a Director resigns or is unable to attend. The gender ratio is therefore in compliance with the law which states that companies with more than 50 people should ensure that the ratio of either gender on the board of directors and alternate board should not be less than 40%. Five Directors and two Alternates are independent of the Arion Bank, its management and major shareholders.

On 26 March 2020 the Bank announced that Herdís Dröfn Fjeldsted, vice chairman of the Board of Directors, had taken over as CEO of Valitor on a temporary basis. It was announced in November 2020 that Herdís Dröfn had been appointed CEO on a permanent basis. During this period Herdís Dröfn has not participated in the activities of the Board of Directors and in her absence an Alternate Director has taken a seat on the board.

The Board of Directors of Arion Bank is committed to good corporate governance and endeavours to promote responsible behaviour and corporate culture within Arion Bank for the benefit of all stakeholders. Arion Bank has to this end devised a corporate governance statement which is designed to help foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Arion Bank was recognized as a company which had achieved excellence in corporate governance, initially in December 2015 and again in April 2019. The recognition applies for three years unless significant changes are made to the Bank's management or ownership.

The Board of Directors is the supreme authority in the affairs of the Bank between shareholders' meetings. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The CEO hires the Executive Management. There are four Board subcommittees: the Board Audit Committee, the Board Risk Committee, the Board Credit Committee and the Board Remuneration Committee. The Board has temporarily set up a subcommittee, the Board Tech Committee, which will advise the board and executive committee on technological issues at the Bank over the next few years. One of the committee members on the Board Audit Committee is not a Board member and is independent of the Bank and its shareholders.

The main roles of the Board, as further specified in the rules of procedure of the Board, include approving the Bank's strategy, supervising financial affairs and accounting and ensuring that appropriate internal controls are in place. The Board ensures that the Bank has active Internal Audit, Compliance and Risk Management departments. The Internal Auditor is appointed by the Board of Directors and works independently of other departments of the Bank in accordance with a charter from the Board. The Internal Auditor provides independent and objective assurance and advice designed to add value and improve the Bank's operations. The Compliance Officer, who reports directly to the CEO, works independently within the Bank in accordance with a charter from the Board. The main role of Compliance is to ensure that the Bank has in place proactive measures to reduce the risk of rules being breached in the course of its activities. Compliance is also responsible for coordinating the Bank's measures against money laundering and terrorist financing. The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a monitoring and training schedule for employees which addresses the laws and rules under which the Bank operates.

Corporate governance at Arion Bank is described in more detail in the Bank's Corporate Governance Statement which is contained in the unaudited appendix to the Financial Statement and on the website www.arionbanki.is. The Corporate Governance Statement is based on legislation, regulations and recognized guidelines in force when the Bank's annual financial statements are adopted by Board of Directors. This statement is prepared in accordance with the Financial Undertakings Act No. 161/2002 and Guidelines on Corporate Governance, 5th edition, issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland in May 2015. Corporate governance at Arion Bank complies with the guidelines with one exceptions, which is explained in more detail in the Corporate Governance Statement.

Endorsement and statement
by the Board of Directors and the CEO

Sustainability and non-financial reporting

Arion Bank is a strongly capitalized bank which provides financial services to companies and individuals with the aim of creating future value for the benefit of our customers, shareholders, partners and society as a whole. Arion Bank's sustainability policy bears the title Together we make good things happen and indicates that the Bank intends to act as a role model by promoting responsible and profitable business practices, which take into account the environment, the economy and the society in which we live and work.

We refer to Arion Bank's values as cornerstones and they are designed to provide guidance when making decisions and in everything the employees say and do. They refer to the Bank's role, attitude and conduct. The values are we find solutions, we make a difference, we get things done, and we say what we mean. The Bank's code of conduct is designed to support responsible decision making and has been approved by the Board of Directors.

In September 2019 the Bank became a signatory to the United Nations Principles for Responsible Banking (UN PRB). These principles align banking with international goals and commitments such as the UN Sustainable Development Goals and the Paris Climate Agreement. In December 2019 the Board of Directors adopted a new environment and climate policy which is aligned with the principles.

Arion Bank's activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. This information is contained in the Bank's annual and sustainability report which will be published on 17 February 2021. The report also describes the company's business model, non-financial performance indicators, the company's sustainability policy and information on the due diligence process. It also discusses human rights and how the company is tackling financial crime. The first steps have been taken towards evaluating the main risks to the Bank with respect to the above factors and this analysis and its results are contained in the report.

Non-financial reporting is based on the Global Reporting Initiative, GRI Core. When sharing information on non-financial factors of the business the ESG reporting guide for the Nasdaq Nordic and Baltic exchanges and the 10 Principles of the UN Global Compact are also used a reference. The Bank also looks to the UN Sustainable Development Goals.

The Annual and Sustainability Report will be available online here: https://arsskyrsla2020.arionbanki.is/english/

Endorsement of the Board of Directors and the Chief Executive Officer

The Consolidated Financial Statements of Arion Bank for the year ended 31 December 2020 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 Consolidated Financial Statements give a true and fair view of the financial performance and cash flow of the Group for the year ended 31 December 2020 and its financial position as at 31 December 2020.

Furthermore, in our opinion the Consolidated 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 Consolidated Financial Statements of Arion Bank for the year ended 31 December 2020 and confirm them by means of their signatures. The Board of Directors and the CEO recommend that the Consolidated Financial Statements be approved at the Annual General Meeting of Arion Bank.

Reykjavík, 10 February 2021

Board of Directors

Brynjólfur Bjarnason, Chairman
Gunnar Sturluson
Liv Fiksdahl
Paul Richard Horner
Renier Lemmens
Sigurbjörg Ásta Jónsdóttir
Steinunn Kristín Thórdardóttir

Chief Executive Officer

Benedikt Gíslason

Independent Auditor's report

To the Board of Directors and shareholders of Arion Bank.

Opinion

We have audited the Consolidated Financial Statements of Arion Bank hf. for the year ended December 31, 2020 which comprise the Consolidated Income Statement, Consolidated Statement of Comprehensive Income, Consolidated Statement of Financial Position, Consolidated Statement of Changes in Equity, Consolidated Statement of Cash Flows for the year then ended and the notes to the Consolidated Financial Statements, including a summary of significant accounting policies.

In our opinion, the accompanying Consolidated Financial Statements give a true and fair view of the consolidated financial position of Arion Bank hf. as at December 31, 2020, its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Our opinion in this report on the consolidated financial statements is consistent with the content of the additional report that has been submitted to the parent company´s audit committee in accordance with the EU Audit Regulation 537/2014 Article 11.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Consolidated Financial Statements section of our report. We are independent of Arion Bank hf. in accordance with the International Ethics Standards Board for Accountants’ Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. This includes that, based on the best of our knowledge and belief, no prohibited services referred to in the EU Audit Regulation 537/2014 Article 5.1 has been provided to the audited company or, where applicable, its parent company or its controlled companies within the EU. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the Consolidated Financial Statements of the current period. These matters were addressed in the context of our audit of the Consolidated Financial Statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Key Audit Matters	***How the matter was addressed in the audit***
Impairment charges for loans and provisions for guarantees	
Loans for the Group amounted to ISK 834,998 million at 31 December 2020, and the total allowance account for the Group amounted to ISK 13,157 million (including off-balance positions) at 31 December 2020. The Group valuate it´s impairment on loans based on IFRS 9 resulting in impairment charges are recognised when losses are expected based on forecasting models. Management has provided further information about the accounting policies for expected credit losses in note 56 and about loan impairment charges and provisions for guarantees in notes 15 and 42. Measurement of loan impairment charges for loans and provisions for guarantees is deemed a key audit matter as the determination of assumptions for expected credit losses is subjective due to the level of judgement applied by Management. The most significant judgements are: • Assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Timely identification of exposures with significant increase in credit risk and credit impaired exposures. • Valuation of collateral and assumptions used for manually assessed credit-impaired exposures.	Based on our risk assessment and industry knowledge, we have examined the impairment charges for loans and provisions for guarantees and evaluated the methodology applied as well as the assumptions made according to the description of the key audit matter. As part of our audit, we have examined the Group’s implementation of IFRS 9. As part of our review of the implementation we performed substantive procedures on the Group’s impairment models and reviewed the methodology implemented for expected credit loss calculations. We used risk modelling specialists as well as IFRS specialists as part of our audit. Our examination included the following elements: • Testing of key controls over key assumptions used in the expected credit loss models to assess the credit risk related to the exposure and the expected future cash flows of the customer. • Substantively testing evidence to support the assumptions used in the expected credit loss models applied in stage allocation, assumptions applied to derive lifetime possibility of default and methods applied to derive loss given default. • Testing of key controls and substantive testing of timely identification of exposures with significant increase in credit risk and timely identification of credit impaired exposures. • Testing of key controls over models and manual processes for valuation of collateral used in the expected credit loss calculations. • Substantively testing evidence to support appropriate determination of assumptions for loan impairment charges and provisions for guarantees including valuation of collateral and assumptions of future cash flows on manually assessed credit impaired exposures.

Independent Auditor's report

Key Audit Matters	*How the matter was addressed in the audit*
Revenue recognition	
Interest income is a key element to the core business of the bank. This is the single largest item of the consolidated income statement. Interest income is subject to contractual terms and highly reliant on IT controls and other controls within the Bank's control environment. Therefore, we consider the interest income as key audit matter. The basis for revenue recognition and accounting policies are presented in note 51 to the consolidated financial statements.	We reviewed the policies, processes and controls surrounding the revenue recognition. We have tested relevant controls related to accounting for interest income. We have tested the appropriateness of the interest calculation in accordance with IFRS. We tested interest income by select sample of loans and compare the underlying data to the loans system. In addition, we performed analytical procedures on interest income. The banks applications controls for the IT systems were tested for interest calculation. Furthermore, we selected sample of loans to ensure that interest is being accrued correctly.
Assets and disposal groups held for sale valuation	
Disposal groups held for sale amounts to ISK 15,788 million among assets in the Consolidated Balance sheet at year-end and the comparable amount among debts is ISK 16,183 million. The Group evaluates this category of assets in accordance with IFRS 5 and according to note 29 there are three disposal companies for consideration where the Bank holds all the share capital. Valuation for Disposal groups held for sale involves management judgements and the assumptions involve a high level of uncertainties, which can be challenging to verify. The valuation is based on many assumptions like future growth, yield, value of cash generating units etc. that can have a significant impact on the valuation and therefore the Bank's net income and balance sheet. The application of IFRS 5 'Non-Current Asset Held for Sale and Discontinued operations' is significant to our audit also because the assessment of the classification can be complex. We need to make sure that the management is committed to a plan to sell and the asset is available for immediate sale.	Based on our risk assessment and industry knowledge, we have examined the valuation of assets and disposal groups held for sale and evaluated the methodology applied as well as the assumptions made according to the description of the key audit matter. We reviewed the policies, processes and controls surrounding the valuation for groups held for sale. We have tested relevant controls related to accounting for groups available for sale. We have tested the appropriateness of the classification of groups available for sale is in accordance with IFRS 5. We have used valuation specialist to challenge the management judgement and key assumption for the valuation.

Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the unaudited appendix to the Financial Statements, 5-year overview, key figures, unaudited quarterly statements in note 6 and Endorsement and statements by the Board of Directors and the CEO.

Our opinion on the Consolidated Financial Statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except the confirmation regarding the Endorsement and the statement by the Board of Directors and the CEO as stated below.

In connection with our audit of the Consolidated Financial Statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the Consolidated Financial Statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information; we are required to report that fact. We have nothing to report in this regard.

In accordance with Paragraph 2 article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying the Endorsement and statements by the Board of Directors and the CEO includes all information required by the Icelandic Financial Statement Act that is not disclosed elsewhere in the Consolidated Financial Statements.

Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements

The Board of Directors and the CEO are responsible for the preparation and fair presentation of the Consolidated Financial Statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and the CEO determines is necessary to enable the preparation of Consolidated Financial Statements that are free from material misstatement, whether due to fraud or error.

In preparing the Consolidated Financial Statements, the Board of Directors and the CEO are responsible for assessing Arion Bank hf.'s ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the company or to cease operations, or has no realistic alternative but to do so.

Independent Auditor's report

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the Consolidated Financial Statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these Consolidated Financial Statements.

As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Indentify and assess the risks of material misstatement of the Consolidated Financial Statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Arion Bank hf.'s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the Consolidated Financial Statements, including the disclosures, and whether the Consolidated Financial Statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated and separate financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Board of Directors and the Board Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Board of Directors and the Board Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with the Board of Directors and the Board Audit Committee, we determine those matters that were of most significance in the audit of the Consolidated Financial Statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

In addition to our work as the auditors of Arion Bank hf., Deloitte has provided the firm with permitted additional services such as review of interim financial statements and other assurance engagement,. Deloitte has in place internal procedures in order to ensure its independence before acceptance of additional services. Arion Bank hf. audit committee also has in place internal procedures to approve additional services before they commence. The audit committee also evaluates the independence of the company's auditors on yearly basis in order to ensure their independence and objectivity.

Deloitte was appointed auditor of Arion Bank hf. By the general meeting of shareholders on 17. March. 2020. Deloitte have been elected since the general meeting 2015.

Kópavogur, 10 February 2021

Deloitte ehf.

Páll Grétar Steingrímsson
State Authorized Public Accountant

Haukur Ingi Hjaltalín
State Authorized Public Accountant

Consolidated Income Statement

	Notes	2020	2019
Interest income		51,730	58,307
Interest expense		(20,572)	(27,990)
Net interest income	7	**31,158**	**30,317**
Fee and commission income		13,225	11,499
Fee and commission expense		(1,583)	(1,549)
Net fee and commission income	8	**11,642**	**9,950**
Net insurance income	9	3,071	2,886
Net financial income	10	2,745	3,212
Share of profit of associates	26	-	756
Other operating income	11	2,148	877
Other net operating income		**7,964**	**7,731**
Operating income		**50,764**	**47,998**
Salaries and related expenses	12	(12,332)	(14,641)
Other operating expenses	13	(12,109)	(12,222)
Operating expenses		**(24,441)**	**(26,863)**
Bank levy	14	(1,301)	(2,984)
Net impairment	15	(5,044)	(382)
Earnings before income tax		**19,978**	**17,769**
Income tax expense	16	(3,231)	(3,714)
Net earnings from continuing operations		**16,747**	**14,055**
Discontinued operations held for sale, net of income tax	17	(4,278)	(12,955)
Net earnings		**12,469**	**1,100**

Attributable to

	Notes	2020	2019
Shareholders of Arion Bank hf.		12,476	1,096
Non-controlling interest		(7)	4
Net earnings		**12,469**	**1,100**

Earnings per share

	Notes	2020	2019
Basic and diluted earnings per share attributable to the shareholders of Arion Bank (ISK)	18	7.24	0.61

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Comprehensive Income

	Notes	2020	2019
Net earnings		**12,469**	**1,100**
Net gain on financial assets carried at fair value through OCI, net of tax		(164)	482
Realized net loss on financial assets carried at fair value through OCI, net of tax, transferred to the Income Statement	10	(112)	(433)
Changes to reserve for financial instruments at fair value through OCI		**(276)**	**49**
Exchange difference on translating foreign subsidiaries		212	135
Other comprehensive income that is or may be reclassified subsequently to the Income Statement		**(64)**	**184**
Total comprehensive income		**12,405**	**1,284**

Attributable to

		2020	2019
Shareholders of Arion Bank		12,412	1,280
Non-controlling interest		(7)	4
Total comprehensive income		**12,405**	**1,284**

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Financial Position

Assets	Notes	2020	2019
Cash and balances with Central Bank	19	42,136	95,717
Loans to credit institutions	20	28,235	17,947
Loans to customers	21	822,941	773,955
Financial instruments	22-24	227,251	117,406
Investment property	24	6,132	7,119
Investments in associates	26	891	852
Intangible assets	27	9,689	8,367
Tax assets	28	2	2
Assets and disposal groups held for sale	29	16,811	43,626
Other assets	30	18,618	16,864
Total Assets		**1,172,706**	**1,081,855**

Liabilities			
Due to credit institutions and Central Bank	23	13,031	5,984
Deposits	23	568,424	492,916
Financial liabilities at fair value	23	5,240	2,570
Tax liabilities	28	4,262	4,404
Liabilities associated with disposal groups held for sale	29	16,183	28,631
Other liabilities	31	32,714	32,697
Borrowings	23,32	298,947	304,745
Subordinated liabilities	23,33	36,060	20,083
Total Liabilities		**974,861**	**892,030**

Equity			
Share capital and share premium	35	51,331	55,715
Other reserves		11,320	9,493
Retained earnings		135,021	124,436
Total Shareholders' Equity		**197,672**	**189,644**
Non-controlling interest		173	181
Total Equity		**197,845**	**189,825**
Total Liabilities and Equity		**1,172,706**	**1,081,855**

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Changes in Equity

			Restricted reserves									
	Share capital	Share premium	Gain in subs. & assoc., unrealized	Gain in securities, unrealized	Capitalized develop-ment cost	Financial assets at fair value thr. OCI, unrealized	Statutory reserve	Foreign currency trans-lation reserve	Retained earnings	**Total share-holders' equity**	Non-cont-rolling interest	**Total equity**
Equity 1 January 2020	1,773	53,942	6,127	692	459	135	1,637	443	124,436	**189,644**	181	**189,825**
Net earnings (loss)									12,476	**12,476**	(7)	**12,469**
Net fair value gain						(164)				**(164)**		**(164)**
Realized net loss transferred to the Income Statement						(112)				**(112)**		**(112)**
Translation difference								212		**212**		**212**
Total comprehensive income	-	-	-	-	-	(276)	-	212	12,476	**12,412**	(7)	**12,405**
Purchase of treasury stock *	(54)	(4,325)								**(4,379)**		**(4,379)**
Changes in treasury stock **	(0)	(4)								**(4)**		**(4)**
Changes in reserves			1,294	2	595				(1,891)	**-**		**-**
Equity 31 December 2020	1,718	49,613	7,421	694	1,054	(141)	1,637	655	135,021	**197,672**	173	**197,845**

* Refers to the purchase of own shares after the Board of Directors authorized the Bank to initiate a share buy-back program in Iceland and Sweden (the Program) to purchase own shares, which is in line with the authorization granted by the AGM on 20 March 2019. The purpose of the Program was to reduce the Bank's equity (in line with the Bank's dividend policy). When the Program was initiated on 31 October 2019, the Bank was authorized to purchase up to 59 million own shares in total under the Program, corresponding to 3.25% of the issued share capital, or for up to ISK 4.5 billion at market value. In January 2020 the FSA approved the buy-back of an additional 41 million own shares or for up to ISK 3.5 billion at market value, bringing the total amount of the share Program to 100 million shares or ISK 8.0 billion at market value. The Program continued until the AGM in March 2020. At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020.

** In 2018 approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant program, an employee who resigned within the vesting period of two years, returned the shares to the Bank. The vesting period ended in June 2020.

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Changes in Equity

			Restricted reserves									
	Share capital	Share premium	Gain in subs. & assoc., unrealized	Gain in securities, unrealized	Capitalized develop- ment cost	Financial assets at fair value thr. OCI unrealized	Statutory reserve	Foreign currency trans- lation reserve	Retained earnings	**Total share- holders' equity**	Non- cont- rolling interest	**Total equity**
Equity 1 January 2019	1,814	57,196	12,373	417	-	87	1,637	308	126,897	**200,729**	130	**200,859**
Net earnings									1,096	**1,096**	4	**1,100**
Net fair value gain						481				**481**		**481**
Realized net loss transferred to the Income Statement						(433)				**(433)**		**(433)**
Translation difference								135		**135**		**135**
Total comprehensive income	-	-	-	-	-	48	-	135	1,096	**1,279**	4	**1,284**
Dividend paid									(9,069)	**(9,069)**		**(9,069)**
Purchase of treasury stock *	(41)	(3,242)								**(3,283)**		**(3,283)**
Changes in treasury stock **	-	(13)								**(13)**		**(13)**
Changes in reserves			(6,246)	275	459				5,512	**-**		**-**
Acquisition of a subsidiary										**-**	47	**47**
Equity 31 December 2019	1,773	53,941	6,127	692	459	135	1,637	443	124,436	**189,644**	181	**189,825**

* Refers to the purchase of own shares following an approval of the Board of Directors to authorize the Bank to initiate share buy-back programs in Iceland and Sweden (the Programs) to purchase own shares, which was in line with an authorization granted by the AGM on 20 March 2019. The purpose of the Programs was to reduce the Bank's equity (in line with the Bank's dividend policy). The Bank had permission to purchase up to 59,000,000 share in total under the Programs, corresponding to 3.25% of the current issued share capital, or for up to ISK 4.5 billion market value.

** In 2018 approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees stock grant program, an employee who resigned within the vesting period of two years, returned the shares to the Bank.

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Consolidated Statement of Cash flows

Operating activities	2020	2019
Net earnings	12,469	1,100
Non-cash items included in net earnings	(11,888)	(10,284)
Changes in operating assets and liabilities		
Loans to credit institutions, excluding bank accounts	(3,843)	16,152
Loans to customers	(29,810)	62,318
Financial instruments and financial liabilities at fair value	(108,835)	(2,047)
Deposits	69,631	24,457
Borrowings	(26,036)	(119,010)
Other changes in operating assets and liabilities	20,000	(7,098)
Interest received	47,268	56,705
Interest paid	(20,271)	(27,641)
Dividend received	68	132
Income tax paid	(3,361)	(4,341)
Net cash to operating activities	**(54,608)**	**(9,557)**
Investing activities		
Proceeds from sale of subsidiaries and associates	96	740
Acquisition of associates	(39)	(19)
Acquisition of subsidiaries	-	(80)
Acquisition of intangible assets	(2,164)	(2,750)
Proceeds from sale of property and equipment	1,442	643
Acquisition of property and equipment	(1,115)	(498)
Net cash used in investing activities	**(1,780)**	**(1,964)**
Financing activities		
Issued subordinated liabilities	12,805	13,625
Purchase of treasury stock	(4,381)	(3,283)
Dividend paid to shareholders of Arion Bank	-	(9,069)
Net cash from in financing activities	**8,424**	**1,273**
Net decrease in cash and cash equivalents	(47,964)	(10,248)
Cash and cash equivalents at beginning of the year	102,186	110,589
Effect of exchange rate changes on cash and cash equivalents	4,062	1,845
Cash and cash equivalents	**58,284**	**102,186**
Cash and cash equivalents		
Cash and balances with Central Bank	42,136	95,717
Bank accounts	22,354	16,437
Mandatory reserve deposit with Central Bank	(6,206)	(9,968)
Cash and cash equivalents	**58,284**	**102,186**
Non-cash changes due to acquisition of TravelCo		
Assets and disposal groups held for sale	-	1,632
Loans to customers	-	(1,632)

* Interest paid includes interest credited to deposit accounts at the end of the year.

The accompanying Notes are an integral part of these Consolidated Financial Statements

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

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Notes to the Consolidated Financial Statements

General information

Arion Bank hf., the Parent Company, was established on 18 October 2008 and is incorporated and domiciled in Iceland. The registered office of Arion Bank hf. is located at Borgartún 19, Reykjavík. The Consolidated Financial Statements for the year ended 31 December 2020 comprise the Parent Company and its subsidiaries (together referred to as "the Group").

1. Basis of preparation

The Consolidated Financial Statements were approved and authorized for publication by the Board of Directors of Arion Bank on 10 February 2021.

In preparing the Consolidated Financial Statements, the Bank has applied the concept of materiality to the presentation and level of disclosure. Only essential and mandatory information is disclosed which is relevant to an understanding by the reader of the Consolidated Financial Statements.

Statement of compliance

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), 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 same accounting policies, presentation and methods of computation are followed in these Consolidated Financial Statements as were applied in the Consolidated Financial Statements for the year ended 31 December 2019.

Basis of measurement

The Consolidated Financial Statements have been prepared on a historical cost basis except for the following:

- bonds and debt instruments, shares and equity instruments, short positions in listed bonds and equities and derivatives. For details on the accounting policy, see Note 56;
- investment properties are measured at fair value; and
- non-current assets and disposal groups held for sale are stated at the lower of their carrying amounts and fair value, less cost to sell.

Functional and presentation currency

The Consolidated 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 year the exchange rate of the ISK against USD was 127.64 and 156.09 for EUR (31.12.2019: USD 121.04 and EUR 135.83).

2. Changes in accounting policies

The Bank has not early adopted any standards, interpretations or amendments that have been issued but are not effective.

3. Significant accounting estimates and judgments 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.

Estimates and assumptions

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year, are described below. The Group based its assumptions and estimates on parameters available when the Consolidated Financial Statement were prepared. Existing circumstances and assumptions about future developments, however, may change due to market changes or circumstances arising that are beyond the control of the Group. Such changes are reflected in the assumptions when they occur.

Notes to the Consolidated Financial Statements

3. Significant accounting estimates and judgements in applying accounting policies, continued

Impairment of financial assets

The book value of financial assets which fall under the impairment requirements of IFRS 9 are presented net of expected credit losses in the statement of financial position. On a monthly basis expected credit losses are recalculated for each asset, the calculations being derived from PD, LGD and EAD models. In addition to the model outcomes, the assessment of expected credit losses is based on three key factors: management's assumptions regarding the development of macroeconomic factors over the next three years, how those factors affect each model and how to estimate a significant increase in credit risk. The assumptions for macroeconomic development are incorporated into each model for three scenarios: a base case, an optimistic case and a pessimistic case. Management estimates the probability weight for each scenario used for calculations of the probability weighted expected credit losses. The amount of expected credit losses to be recognized is dependent on the Bank's definition of significant increase in credit risk, which controls the impairment stage each asset is allocated to. Management has estimated factors to measure significant increase in credit risk from origination, by comparison of changes in PD values, annualized lifetime PD values, days past due and watch list. For further information see Note 56.

Macroeconomic outlook

Due to the unprecedented circumstances caused by the Covid-19 pandemic, Arion Bank has made changes to its macroeconomic outlook used for IFRS 9 provision calculations from the ones used in calculations for the 2019 impairment provisions. Arion Bank has followed the guidelines of the European supervisors and the Central Bank of Iceland and used moderation in the application of impairment calculations considering the level of economic uncertainty. In doing so, the Bank has estimated the effects of the governmental stimulus programs, general and specific payment moratoria and other actions on expected default rates. The unemployment rate is the key macro factor that drives the forward-looking expectation of defaults. It is assumed that there will be a sharp increase in unemployment which will recover, and the speed of the recovery varies between scenarios, as quarantine restrictions and travel bans are eased.

Unemployment levels and scenarios have been updated from the ones used for Q3 2020 and are more in line with current economic projections. Expected unemployment levels have changed significantly from the ones used at year end 2019 and slightly from the ones used in Q3 2020. The unemployment forecast is now higher and expected to normalize over a longer time period than estimated in 2019. Furthermore, the likelihood of the pessimistic scenario has been increased from year-end 2019. Among the steps taken to address the uncertainty and information that is available but not addressed by the models are (1) shortening of the forecasting period, (2) application of expert judgment in cases where economic forecasts are outside the range of the Bank's macro models, (3) assessment of mitigating effects on default rates in the near-term, (4) adjustment of collateral haircuts to more accurately reflect the realized economic development due to Covid-19, and (5) a management overlay over credit rating scores for specific groups of assets which have been most affected. The scenarios and the weights assigned to them will continue to be reexamined in the coming quarters as uncertainty over the local and global impact of Covid-19 is reduced and vaccines are rolled out. For further information about macroeconomic forecast, see Note 42.

Arion Bank has concluded that credit risk relating to the tourism sector and to counterparties in payment moratoria has significantly increased. The increase has been taken into account since Q1 2020 for tourism and Q3 for payment moratoria, which means that all such exposures are in Stage 2 as of year-end 2020, excluding financial assets to entities owned by the government. Furthermore, the credit rating of affected counterparties has been lowered in line with the increase of expected credit losses. The extent of the related impact on other industries and supporting businesses is unclear, Arion Bank has taken steps to approximate the effects as mentioned above. Companies that receive the court-determined status of temporary financial restructuring as per Act No. 57/2020 are transferred to Stage 3. The Bank continues to monitor developments closely and will adjust its provisions accordingly.

Assets and disposal groups held for sale

Legal entities acquired exclusively with a view to resale, and discontinued operations held for sale are measured at the lower of carrying amount and fair value, less cost to sell. For the most part, fair value at the date of classification of these legal entities and discontinued operations was calculated using valuation models based on discontinued future cash flows that incorporated significant non-market observable inputs and assumptions. The use of reasonably possible alternative inputs and assumptions to these models, in particular changes to the discount rate employed (representing the required rate of return on equity), could have an impact on the value of these disposal groups.

Real estates acquired exclusively with a view to resale are measured at the lower of carrying amount and fair value, less cost to sell. Fair value at the date of classification is based on independent property values or management valuation. As the fair value measurement of real estates is based on valuation techniques, there is some uncertainty about the actual fair value of assets.

Impairment of intangible assets

The carrying amounts of goodwill, infrastructure and customer relationship and related agreements are reviewed annually to determine whether there is any indication of impairment. If any such indication exists the asset's recoverable amount is estimated. An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in the Consolidated Income Statement. The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

Revaluation of investment properties

The Group carries its investment properties at fair value, with changes in fair value being recognized in the statement of profit or loss. For investment properties, either a valuation methodology based on present value calculations is used, as there is a lack of comparable market data because of the nature of the properties, or the investment properties are valued by reference to transactions involving properties of a similar nature, location and condition.

Notes to the Consolidated Financial Statements

4. The Group

Shares in the main subsidiaries in which Arion Bank holds a direct interest	Operating activity	Currency	Equity interest 2020	Equity interest 2019
Eignabjarg ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Leiguskjól ehf., Lágmúli 6, Reykjavík, Iceland	Rental guarantee	ISK	51.0%	51.0%
SRL slhf., Borgartún 19, Reykjavík, Iceland	Real estate	ISK	100.0%	100.0%
Stefnir hf., Borgartún 19, Reykjavík, Iceland	Asset management	ISK	100.0%	100.0%
Valitor hf., Dalshraun 3, Hafnarfjördur, Iceland	Payment solutions	ISK	100.0%	100.0%
VISA Ísland ehf., Borgartún 19, Reykjavík, Iceland	Holding company	ISK	100.0%	100.0%
Vördur tryggingar hf., Borgartún 25, Reykjavík, Iceland	Insurance	ISK	100.0%	100.0%

The subsidiaries Eignabjarg ehf. (holding company of Stakksberg ehf. and Sólbjarg ehf.) and Valitor hf. are classified as held for sale in accordance with IFRS 5.

In 2020 Valitor Holding hf. merged into Valitor hf.

Amounts are in ISK millions

Notes to the Consolidated 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.

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.

5. Operating segments

Markets

Markets comprises Asset Management and Capital Markets. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. Asset Management also administers pension funds. Asset management comprises Institutional Asset Management, Private Banking and Pension Fund Administration. The operation of Stefnir hf. is presented under the segment. Stefnir hf. is an independently operating financial company owned by Arion Bank and manages a broad range of mutual funds, investment funds and institutional investor funds. Arion Bank also offers comprehensive selection off funds from some of the leading international fund management companies. Capital Markets is a securities brokerage and brokers listed securities transactions for the Bank’s international and domestic clients on all the world’s major securities exchanges.

Corporate & Investment Banking

Corporate & Investment Banking services large and medium-sized corporate clients and investors, both in Iceland and internationally. The division is divided into Corporate Banking and Corporate Finance.

Corporate Banking's experienced account managers specialize in key economic sectors such as retail and services, seafood, energy and real estate. 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, partly in syndicates with other Icelandic banks and international banks.

Arion Bank's Corporate Finance works closely with Corporate Banking, providing customers with various financial advisory and capital raising services, including M&A and LBO services. Furthermore, Corporate Finance offers financial structuring advice, as well as various services on public offerings of securities.

Retail Banking

Retail Banking provides a comprehensive range of products and services, including mortgage loans, savings and current accounts, vehicle and equipment financing, factoring, cards, pension services, insurance and funds, to both individuals and SMEs. Retail Banking has a strong focus on digital banking solutions, using the online bank and the Arion mobile app as key channels. Retail Banking operates out of several branches across Iceland with over 100,000 customers.

Treasury

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Treasury is a market maker in Iceland in domestic securities and FX. Treasury is responsible for funds' transfer pricing and hedging and pricing of financial products. FX brokerage is part of the Treasury unit. Treasury also handles all debt issuance both in the domestic and foreign markets and maintaining the Banks credit ratings.

Vördur

The subsidiary Vördur is the fourth largest insurance company in Iceland, providing non-life and life insurance.

Subsidiaries

Subsidiaries include the subsidiaries SRL slhf., which holds the main part of investment property of the Group and the holding companies VISA Ísland ehf. and other smaller entities of the Group. The subsidiaries Valitor, Stakksberg and Sólbjarg (both subsidiaries of Eignabjarg) are classified as disposal groups held for sale in accordance with IFRS 5.

Supporting units

Supporting units include the Bank's headquarters which carry out support functions such as the CEO office, Risk Management, Finance (excluding Treasury) and IT. The information presented relating to the supporting units 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.

Other information

At the beginning of 2020 the proportion of deposits from corporate customers divided between Corporate & Investment Banking and Retail Banking changed. Deposits amounting to approx. ISK 50 billion were transferred from Retail Banking to Corporate & Investment Banking. At the same time direct income and expense from those deposits were transferred between divisions. As a result of these changes the figures are not fully comparable with those from 2019, mainly reflected in Net interest income.

Notes to the Consolidated Financial Statements

5. Operating segments, continued

2020	Markets and Stefnir	Corporate & Investment Banking	Retail Banking	Treasury	Vördur	Other sub-sidiaries	Supporting units and elimi-nations	Total
Net interest income	976	10,518	15,414	4,631	172	(389)	(164)	31,158
Net fee and commission income	3,962	3,110	4,575	550	(171)	(647)	263	11,642
Net insurance income	-	-	-	-	3,145	-	(74)	3,071
Net financial income	142	(144)	-	964	1,735	38	10	2,745
Share of profit of associates	1	(48)	-	-	-	(1)	48	-
Other operating income	13	102	237	-	(12)	1,599	209	2,148
Operating income	5,094	13,538	20,226	6,145	4,869	600	292	50,764
Operating expenses	(1,828)	(1,301)	(5,423)	(608)	(2,449)	(179)	(12,653)	(24,441)
Allocated expenses	(1,780)	(2,634)	(5,880)	(1,127)	(21)	(6)	11,448	-
Bank levy	(35)	(387)	(579)	(300)	-	-	-	(1,301)
Net impairment	-	(6,043)	(1,114)	(4)	-	4,546	(2,429)	(5,044)
Earnings (loss) before income tax	1,451	3,173	7,230	4,106	2,399	4,961	(3,342)	19,978
Net seg. rev. from ext. customers	3,261	19,642	32,209	(10,850)	2,135	4,218	149	50,764
Net seg. rev. from other segments	1,833	(6,104)	(11,983)	16,995	2,734	(3,618)	143	-
Operating income	5,094	13,538	20,226	6,145	4,869	600	292	50,764
Loans to customers	41	308,657	515,115	66	-	4	(942)	822,941
Financial instruments	43,809	434	-	159,825	22,450	2,869	(2,136)	227,251
Other external assets	3,298	6,640	3,197	69,380	5,889	38,290	(4,180)	122,514
Internal assets	32,045	-	-	238,218	1,894	1,322	(273,479)	-
Total assets	79,193	315,731	518,312	467,489	30,233	42,485	(280,737)	1,172,706
Deposits	64,657	103,648	346,224	64,565	-	-	(10,670)	568,424
Other external liabilities	6,698	2,790	4,778	349,329	19,694	19,736	3,412	406,437
Internal liabilities	-	149,973	123,506	-	-	-	(273,479)	-
Total liabilities	71,355	256,411	474,508	413,894	19,694	19,736	(280,737)	974,861
Allocated equity	7,838	59,320	43,805	53,594	10,539	22,749	-	197,845

Income taxes and discontinued operations held for sale are excluded from the profit and loss segment information.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

5. Operating segments, continued

2019	Markets and Stefnir	Corporate & Investment Banking	Retail Banking	Treasury	Vördur	Other sub-sidiaries	Supporting units and elimi-nations	Total
Net interest income	1,017	9,129	17,303	3,438	228	(628)	(170)	30,317
Net fee and commission income	4,318	1,936	4,803	(196)	(80)	(940)	109	9,950
Net insurance income	-	-	-	-	2,929	-	(43)	2,886
Net financial income	219	(222)	(26)	940	1,321	638	342	3,212
Share of profit of associates	-	-	-	-	-	-	756	756
Other operating income	25	(17)	432	11	20	552	(146)	877
Operating income	5,579	10,826	22,512	4,193	4,418	(378)	848	47,998
Operating expenses	(1,920)	(1,471)	(6,802)	(385)	(2,240)	(63)	(13,982)	(26,863)
Allocated expenses	(1,470)	(3,401)	(6,207)	(1,040)	(16)	(6)	12,140	-
Bank levy	(142)	(726)	(1,064)	(1,052)	-	-	-	(2,984)
Net impairment	-	(8,879)	2,287	3	-	6,208	(1)	(382)
Earnings (loss) before income tax	2,047	(3,651)	10,726	1,719	2,162	5,761	(995)	17,769
Net seg. rev. from ext. customers	2,832	20,244	34,637	(15,950)	4,157	1,199	879	47,998
Net seg. rev. from other segments	2,747	(9,418)	(12,125)	20,143	261	(1,577)	(31)	-
Operating income	5,579	10,826	22,512	4,193	4,418	(378)	848	47,998
Loans to customers	15	311,945	470,255	169	-	-	(8,429)	773,955
Financial instruments	28,508	6,170	-	62,456	19,113	4,742	(3,583)	117,406
Other external assets	613	2,430	4,944	113,640	5,909	50,556	12,402	190,494
Internal assets	40,530	-	-	310,444	2,006	3,217	(356,197)	-
Total assets	69,666	320,545	475,199	486,709	27,028	58,515	(355,807)	1,081,855
Deposits	60,609	25,556	362,881	60,609	-	-	(16,739)	492,916
Other external liabilities	1,931	1,516	(51,481)	375,620	16,869	37,530	17,129	399,114
Internal liabilities	-	236,309	119,888	-	-	-	(356,197)	-
Total liabilities	62,540	263,381	431,288	436,229	16,869	37,530	(355,807)	892,030
Allocated equity	7,126	57,164	43,911	50,480	10,159	20,985	-	189,825

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters, unaudited

2020	Q1	Q2	Q3	Q4	Total
Net interest income	7,253	7,857	7,989	8,059	31,158
Net fee and commission income	3,076	2,688	2,762	3,116	11,642
Net insurance income	501	761	1,043	766	3,071
Net financial income	(2,000)	2,691	692	1,362	2,745
Share of (loss) profit of associates	(24)	(5)	51	(22)	-
Other operating income	170	71	475	1,432	2,148
Operating income	8,976	14,063	13,012	14,713	50,764
Salaries and related expense	(3,130)	(3,577)	(2,504)	(3,121)	(12,332)
Other operating expense	(3,077)	(2,818)	(2,728)	(3,486)	(12,109)
Operating expenses	(6,207)	(6,395)	(5,232)	(6,607)	(24,441)
Bank levy	(331)	(324)	(383)	(263)	(1,301)
Net impairment	(2,860)	(918)	(1,340)	74	(5,044)
Earnings before income tax	(422)	6,426	6,057	7,917	19,978
Income tax expense	(860)	(1,468)	(1,096)	193	(3,231)
Net earnings from continuing operations	(1,282)	4,958	4,961	8,110	16,747
Discontinued operations, net of tax	(889)	(45)	(995)	(2,349)	(4,278)
Net earnings (loss)	(2,171)	4,913	3,966	5,761	12,469

2019	Q1	Q2	Q3	Q4	Total
Net interest income	7,434	7,808	7,382	7,693	30,317
Net fee and commission income	2,218	2,478	2,639	2,615	9,950
Net insurance income	253	823	1,087	723	2,886
Net financial income	766	1,023	934	489	3,212
Share of profit (loss) of associates	727	(8)	30	7	756
Other operating income	310	94	272	201	877
Operating income	11,708	12,218	12,344	11,728	47,998
Salaries and related expense	(3,630)	(3,805)	(4,130)	(3,076)	(14,641)
Other operating expense	(3,232)	(2,814)	(2,810)	(3,366)	(12,222)
Operating expenses	(6,862)	(6,619)	(6,940)	(6,442)	(26,863)
Bank levy	(906)	(912)	(809)	(357)	(2,984)
Net impairment	(1,081)	(988)	484	1,203	(382)
Earnings before income tax	2,859	3,699	5,079	6,132	17,769
Income tax expense	(622)	(891)	(1,278)	(923)	(3,714)
Net earnings from continuing operations	2,237	2,808	3,801	5,209	14,055
Discontinued operations, net of tax	(1,219)	(715)	(3,040)	(7,981)	(12,955)
Net earnings (loss)	1,018	2,093	761	(2,772)	1,100

The half-year results were reviewed by the Bank's auditors. Other quarterly statements and the split between quarters were not audited or reviewed by the Bank's auditors.

Amounts are in ISK millions

Notes to the Consolidated Income Statement

7. Net interest income

2020	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	1,435	-	-	1,435
Loans to credit institutions	188	-	-	188
Loans to customers	46,804	-	-	46,804
Securities	-	1,249	1,889	3,138
Other	165	-	-	165
Interest income	48,592	1,249	1,889	51,730
Interest expense				
Deposits	(6,644)	-	-	(6,644)
Borrowings	(12,030)	-	-	(12,030)
Subordinated liabilities	(1,780)	-	-	(1,780)
Other	(118)	-	-	(118)
Interest expense	(20,572)	-	-	(20,572)
Net interest income	28,020	1,249	1,889	31,158

2019	Amortized cost	Fair value thr. P/L	Fair value thr. OCI	Total
Interest income				
Cash and balances with Central Bank	4,008	-	-	4,008
Loans to credit institutions	619	-	-	619
Loans to customers	52,138	46	-	52,184
Securities	-	608	727	1,335
Other	161	-	-	161
Interest income	56,926	654	727	58,307
Interest expense				
Deposits	(11,949)	-	-	(11,949)
Borrowings	(15,473)	-	-	(15,473)
Subordinated liabilities	(449)	-	-	(449)
Other	(119)	-	-	(119)
Interest expense	(27,990)	-	-	(27,990)
Net interest income	28,936	654	727	30,317

Interest spread	2020	2019
Interest spread (the ratio of net interest income to the average carrying amount of interest bearing assets)	2.9%	2.8%

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

8. Net fee and commission income

	2020			2019		
	Income	Expense	Net income	Income	Expense	Net income
Asset management	4,095	(426)	3,669	3,931	(504)	3,427
Capital markets and corporate finance	1,437	(27)	1,410	1,652	(36)	1,616
Lending and financial guarantees	4,084	-	4,084	2,112	-	2,112
Collection and payment services	1,308	(109)	1,199	1,542	(100)	1,442
Cards and payment solution	1,666	(304)	1,362	1,557	(256)	1,301
Other	635	(717)	(82)	705	(653)	52
Net fee and commission income	13,225	(1,583)	11,642	11,499	(1,549)	9,950

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

Fee and commission income from capital markets and corporate finance includes miscellaneous corporate finance services plus commission from capital markets relating to sales of shares, bonds, FX and derivatives.

Fee and commission income from lending and financial guarantees is mainly related to lending activities, extension fees, advisory services and documentation, notification and payment fees plus fees from the issuing of guarantees on behalf of customers.

Fee and commission income on collection and payment services is generated billing services, such as issuing invoices and payment collection notices, wire transfer services and other payment services.

Commission from cards and payment solutions is mainly from the Bank's issuance of credit and debit cards and other card related commission, e.g. yearly fee on cards and transaction fees.

Other fee and commission income is mainly fees relating to FX transactions at branches and in ATMs, custody and market making on the Icelandic stock exchange.

9. Net insurance income

	2020	2019
Earned premiums, net of reinsurers' share		
Premiums written	12,456	11,796
Premiums written, reinsurers' shares	(478)	(399)
Change in provision for unearned premiums	(497)	(291)
Earned premiums, net of reinsurers' share	11,481	11,106
Claims incurred, net of reinsurers' share		
Claims paid	(7,595)	(7,272)
Claims paid, reinsurers' share	208	157
Change in provision for claims	(951)	(1,104)
Changes in provision for claims, reinsurers' share	(72)	(1)
Claims incurred, net of reinsurers' share	(8,410)	(8,220)
Net insurance income	3,071	2,886

Amounts are in ISK millions

10. Net financial income

	2020	2019
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	4,033	3,056
Net loss on buy back of issued bonds	(700)	(405)
Net loss on fair value hedge of interest rate swap	(178)	(145)
Realized gain on financial assets carried at fair value through OCI	151	585
Net foreign exchange (loss) gain	(561)	121
Net financial income	2,745	3,212

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

	2020	2019
Equity instruments	2,613	2,330
Debt instruments	885	803
Derivatives	535	(31)
Loans	-	(46)
Net gain on financial assets and financial liabilities mandatorily measured at fair value through profit or loss	4,033	3,056

Net loss on fair value hedge of interest rate swap

	2020	2019
Fair value change of interest rate swaps designated as hedging instruments	221	759
Fair value change on bonds issued by the Group attributable to interest rate risk	(399)	(904)
Net loss on fair value hedge of interest rate swap	(178)	(145)

11. Other operating income

	2020	2019
Fair value changes on investment property	580	-
Realised gain on investment property	327	-
Net gain on disposal of assets	722	232
Net gain on assets held for sale	312	382
Other income	207	263
Other operating income	2,148	877

Net gain on assets held for sale

	2020	2019
Income from real estates and other assets	413	484
Expense related to real estates and other assets	(101)	(102)
Net gain on assets held for sale	312	382

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

12. Personnel and salaries

Number of employees

	2020	2019
Average number of full-time equivalent positions during the year	789	866
Full-time equivalent positions at the end of the year	776	801

Number of employees at the parent company

	2020	2019
Average number of full-time equivalent positions during the year	661	755
Full-time equivalent positions at the end of the year	648	687

Salaries and related expenses

	2020	2019
Salaries	10,118	11,715
Defined contribution pension plans	1,498	1,685
Salary-related expenses	1,310	1,700
Capitalization of salaries due to implementation of core systems	(594)	(459)
Salaries and related expenses	12,332	14,641

Salaries and related expenses for the parent company

	2020	2019
Salaries	8,327	10,211
Defined contribution pension plans	1,233	1,469
Salary-related expenses	1,066	1,477
Capitalization of salaries due to implementation of core systems	(594)	(459)
Salaries and related expenses for the parent company	10,032	12,698

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

12. Personnel and salaries, continued

Salary and salary related expenses of ISK 150 million were expensed in 2019 in respect of the resignation of Höskuldur H. Ólafsson, the Bank's former CEO. At the end of September 2019 a new organizational structure was introduced, resulting in a reduction in the number of employees of 12%, or approximately 100 people. Salary and salary related expenses of ISK 1,079 million were expensed in 2019 in respect of these redundancies.

In June 2018 Arion Bank adopted a share-based remuneration programme, when a limited stock grant was offered to all employees of the parent company, excluding internal control units, in connection with the IPO and listing of the Bank. Remuneration was paid in the form of deferred shares with a vesting period of two years. 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 27 million per month from June 2018 to May 2020.

In 2020 the Group made a provision of ISK 67 million (2019: ISK 37 million) for performance plan payments, including salary-related expenses, for which the Bank made no provision (2019: nil). Forty percent of the payment is deferred for three years in accordance with FSA rules on remuneration policies for financial undertakings. At the end of the year the Group's accrual for performance plan payments amounted to ISK 232 million (31.12.2019: ISK 371 million), of which the Bank's accrual amounted to ISK 100 million (31.12.2019: ISK 239 million).

Remuneration to the Board of Directors	2020			2019		
	Fixed remuner-ation*	Additional remuner-ation**	Total	Fixed remuner-ation*	Additional remuner-ation**	Total
Brynjólfur Bjarnason, Chairman of the Board	11.7	6.1	17.8	10.7	5.6	16.3
Herdís Dröfn Fjeldsted, Vice Chairman, Director	2.2	1.3	3.5	8.1	5.7	13.8
Gunnar Sturluson, Director from 9.8.2019	5.9	4.3	10.2	2.2	0.8	3.0
Liv Fiksdahl, Director from 20.3.2019	11.7	2.6	14.3	8.9	1.5	10.4
Paul Richard Horner, Director from 9.8.2019	11.7	4.5	16.2	4.5	0.8	5.3
Renier Lemmens, Director from 20.3.2019	11.7	5.0	16.7	8.9	2.9	11.8
Steinunn Kristín Thórdardóttir, Director ***	11.7	4.9	16.6	17.1	5.0	22.1
Eva Cederbalk, Chairman of the Board until 20.3.2019	-	-	-	4.8	0.6	5.4
Benedikt Gíslason, Director until 26.6.2019	-	-	-	2.8	2.6	5.4
Måns Höglund, Director until 20.3.2019	-	-	-	2.4	1.1	3.5
Alternate directors of the Board	2.7	3.3	6.1	4.5	1.5	6.0
Total remuneration	69.3	32.1	101.4	74.9	28.0	103.0

* Fixed remuneration represents Board Member compensation for their attendance at meetings of the Board of Directors.

** Additional remuneration represents Board Member compensation for their participation in Board Committees.

*** The Annual General Meeting approved that members of the Board of Directors who reside outside of Iceland receive double the monthly salary of Board members who reside in Iceland. In 2019 Steinunn Kristín Thórdardóttir, who resides abroad, received a retroactive correction in this respect.

Remuneration to key management personnel	2020		2019	
	Salaries	Performance-based payments	Salaries	Performance-based payments
Benedikt Gíslason, CEO from 1.7.2019	57.1	-	28.1	-
Ásgeir H. Reykfjörd Gylfason, deputy CEO from 5.9.2019 and MD of Corporate & Investment Banking from 26.9.2019	48.6	-	22.5	-
Ida Brá Benediktsdóttir, MD of Retail Banking	44.4	1.1	40.0	1.9
Margrét Sveinsdóttir, MD of Markets	35.1	1.8	34.8	2.7
Stefán Pétursson, CFO	42.3	1.9	47.2	3.0
Höskuldur H. Ólafsson, CEO until 30.4.2019	-	-	22.6	4.8
Lýdur Thorgeirsson, MD of Investment banking until 26.9.2019	-	-	25.6	-
Rúnar Magni Jónsson, MD of Corporate banking until 26.9.2019	-	-	24.5	1.4
Two managing directors of the Bank's divisions who are members of the Bank's Executive Committee (2019: three until 26.9.2019 and two thereafter)	72.6	-	87.2	5.1
Total remuneration	300.1	4.8	332.5	18.9

Performance based payments in 2020 are deferred payments based on the Group's performance in 2016 (2019: performance in 2015).

Board Members receive remuneration for their involvement in board committees. In addition to 12 Board meetings (2019: 14) during the year 13 Board Credit Committee meetings (2019: 16), 7 Board Audit Committee meetings (2019: 6), 12 Board Risk Committee meetings (2019: 9), 5 Board Remuneration Committee meetings (2019: 5) and 1 Board Tech committee meetings (2019: none) were held. None committee meetings with alternate directors of the Board were held in 2020 (2019: 4).

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

12. Personnel and salaries, continued

The 2020 Annual General Meeting of the Bank held on 17 March 2020 approved the monthly salaries for 2020 for the Chairman, Vice Chairman and for other Board Members of amounts ISK 981,400, ISK 736,200 and ISK 490,900 (2019: ISK 952,800; 714,800; 476,600) respectively. It was also approved that the salary of Alternate Board Members would be ISK 248,600 (2019: ISK 241,400) per meeting, up to a maximum of ISK 490,900 (2019: ISK 476,600) per month. For Board Members resident abroad, the aforementioned amounts are doubled. In addition, it was approved to pay Board Members who serve on board committees of the Bank a maximum of ISK 196,300 (2019: ISK 190,600) per month for each committee they serve on and the Chairman of the board committees ISK 255,000 (2019: ISK 247,600).

13. Other operating expenses

	2020	2019
IT expenses	5,241	4,527
Professional services	970	1,198
Housing expenses	1,142	1,082
Other administration expenses	2,595	3,134
Depositors' and Investors' Guarantee Fund	569	735
Depreciation of property and equipment	617	638
Depreciation of right of use asset	133	128
Amortization of intangible assets	842	780
Other operating expenses	12,109	12,222

Auditor's fee

	2020	2019
Audit and review of the Consolidated Financial Statements for the relevant fiscal year	135	133
Other audit related services for the relevant fiscal year	15	10
Auditor's fee	150	143

14. Bank levy

The Bank levy is 0.145% on total debts excluding tax liabilities, in excess of ISK 50 billion (2019: 0.376%). The tax is assessed on Financial Undertakings but non-financial subsidiaries are exempt from this tax.

15. Net impairment

	2020	2019
Net impairment on financial instruments		
Net change in impairment of cash and balances with Central Bank	-	2
Net change in impairment of loans to credit institutions	(85)	19
Net change in impairment of loans to corporates	(2,139)	(1,216)
Net change in impairment of loans to individuals	227	930
Write offs on loans and receivables to corporates	(2,054)	(1,796)
Write offs on loans and receivables to individuals	(1,223)	(1,321)
Payments on loans and receivables previously written off from corporates	3	20
Payments on loans and receivables previously written off from individuals	98	154
Net change in impairment of financial instruments at FVOCI	(6)	(1)
Net change in impairment of loan commitments, guarantees and unused credit facilities	(568)	207
Net impairment on financial instruments	(5,747)	(3,002)
Other value changes of loans		
Increase in book value of loans to corporates	67	91
Increase in book value of loans to individuals	636	2,529
Other value changes of loans	703	2,620
Net impairment	(5,044)	(382)

Increase in book value of loans to individuals and corporates is mainly due to release of discount from loans acquired with discount during the years 2008 to 2013, both due to impairments and other discount rate than reflected in the interest rates of the loans. The discount release was primarily related to loans that were paid up or sold during the period.

Amounts are in ISK millions

16. Income tax expense

	2020	2019
Current tax expense	3,632	3,174
Deferred tax expense	(401)	540
Income tax expense	3,231	3,714

Reconciliation of effective tax rate

	2020		2019	
Earnings before income tax		19,978		17,769
Income tax using the Icelandic corporate tax rate	20.0%	3,996	20.0%	3,554
Additional 6% tax on Financial Undertakings	3.3%	669	2.3%	402
Non-deductible expenses	0.2%	43	1.0%	181
Tax exempt revenues	(7.4%)	(1,484)	(6.4%)	(1,132)
Non-deductible taxes (bank levy)	1.3%	260	3.4%	597
Tax incentives not recognized in the Income Statement	(0.4%)	(78)	0.1%	21
Other changes	(0.9%)	(175)	0.5%	91
Effective tax rate	16.2%	3,231	20.9%	3,714

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

Tax exempt revenues consist mainly of profit from equity positions.

Bank levy of 0.145% on liabilities exceeding ISK 50 billion is non-deductible (2019: 0.376%).

17. Discontinued operations held for sale, net of income tax

	2020	2019
Net loss from discontinued operations held for sale	(4,275)	(13,681)
Income tax expense	(3)	726
Discontinued operations held for sale, net of income tax	(4,278)	(12,955)

	2020	2019
Valitor hf.	(1,298)	(8,555)
Stakksberg ehf.	(1,425)	(3,799)
Sólbjarg ehf.	(1,555)	(601)
Discontinued operations held for sale, net of income tax	(4,278)	(12,955)

The net loss from Valitor's operation was ISK 1,825 million in 2020 whereas Valitor's negative contribution to the Group, after taking into account the Group's eliminations, was ISK 1,298 million, thereof a loss of ISK 326 million from discontinued operation, net of tax. Operating income of Valitor was ISK 4,838 million, or ISK 5,522 million, after taking into account the Group's eliminations.

For further information about Valitor hf., Stakksberg ehf. and Sólbjarg ehf., see Note 29.

Operating effects of Stakksberg and Sólbjarg are due to fair value changes of underlying assets.

18. Earnings per share

	Continued operations		Discontinued operations		Net Earnings	
	2020	2019	2020	2019	2020	2019
Net earnings attributable to the shareholders of Arion Bank	16,754	14,051	(4,278)	(12,955)	12,476	1,096
Weighted average number of outstanding shares	1,723	1,809	1,723	1,809	1,723	1,809
Basic earnings per share	9.72	7.77	(2.48)	(7.16)	7.24	0.61

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2019: none).

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Notes to the Consolidated Statement of Financial Position

19. Cash and balances with Central Bank

	2020	2019
Cash on hand	3,342	4,206
Cash with Central Bank	32,588	81,543
Mandatory reserve deposit with Central Bank	6,206	9,968
Cash and balances with Central Bank	42,136	95,717

The mandatory reserve deposit with the Central Bank is not available for the Group to use in its daily operations. Minimum reserve requirements of the Central Bank falls into two categories: a fixed reserve requirement and an average maintenance requirement. The fixed reserve requirement is 1%. In March 2020 the Central Bank decided to lower the average reserve requirement from 1% to 0%.

20. Loans to credit institutions

	2020	2019
Bank accounts	22,354	16,437
Other loans	5,982	1,526
Allowance for impairment	(101)	(16)
Loans to credit institutions	28,235	17,947

21. Loans to customers

	Individuals		Corporates		Total	
2020	Gross carrying amount	Book value	Gross carrying amount	Book value	Gross carrying amount	Book value
Overdrafts	12,875	12,176	15,471	14,208	28,346	26,384
Credit cards	12,260	12,062	1,086	1,019	13,346	13,081
Mortgage loans	378,554	377,873	32,175	31,768	410,729	409,641
Other loans	32,122	31,225	350,455	342,610	382,577	373,835
Loans to customers	435,811	433,336	399,187	389,605	834,998	822,941
2019						
Overdrafts	14,421	13,720	18,709	17,780	33,130	31,500
Credit cards	13,028	12,786	1,373	1,281	14,401	14,067
Mortgage loans	310,562	310,195	23,475	23,211	334,037	333,406
Other loans	33,105	31,868	368,453	363,114	401,558	394,982
Loans to customers	371,116	368,569	412,010	405,386	783,126	773,955

The total book value of pledged loans that were pledged against amounts borrowed was ISK 219 billion at the end of the year (31.12.2019: ISK 182 billion). Pledged loans comprised mortgage loans to individuals.

Further analysis of loans is provided in Risk management disclosures.

22. Financial instruments

	2020	2019
Bonds and debt instruments	157,744	65,874
Shares and equity instruments with variable income	18,641	21,600
Derivatives	7,284	6,617
Securities used for economic hedging	43,582	23,315
Financial instruments	227,251	117,406

Amounts are in ISK millions

23. Financial assets and financial liabilities

2020	Amortized cost	Fair value through OCI	Mandatorily at fair value thr. P/L	Total
Financial assets				
Loans				
Cash and balances with Central Bank	42,136	-	-	42,136
Loans to credit institutions	28,235	-	-	28,235
Loans to customers	822,941	-	-	822,941
Loans	893,312	-	-	893,312
Bonds and debt instruments				
Listed	-	136,145	19,075	155,220
Unlisted	-	1,510	1,014	2,524
Bonds and debt instruments	-	137,655	20,089	157,744
Shares and equity instruments with variable income				
Listed	-	-	8,816	8,816
Unlisted	-	-	6,393	6,393
Bond funds with variable income, unlisted	-	-	3,432	3,432
Shares and equity instruments with variable income	-	-	18,641	18,641
Derivatives				
OTC derivatives	-	-	5,002	5,002
Derivatives used for hedge accounting	-	-	2,282	2,282
Derivatives	-	-	7,284	7,284
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	27,215	27,215
Shares and equity instruments with variable income, listed	-	-	16,335	16,335
Shares and equity instruments with variable income, unlisted	-	-	32	32
Securities used for economic hedging	-	-	43,582	43,582
Other financial assets				
Accounts receivable	3,740	-	-	3,740
Other financial assets	5,927	-	-	5,927
Other financial assets	9,667	-	-	9,667
Financial assets	902,979	137,655	89,596	1,130,230
Financial liabilities				
Due to credit institutions and Central Bank	13,031	-	-	13,031
Deposits	568,424	-	-	568,424
Borrowings	298,947	-	-	298,947
Subordinated liabilities	36,060	-	-	36,060
Short position in bonds	-	-	40	40
Short position in equity	-	-	63	63
Short position in bonds used for economic hedging	-	-	666	666
Derivatives	-	-	4,471	4,471
Other financial liabilities	8,011	-	-	8,011
Financial liabilities	924,473	-	5,240	929,713

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

23. Financial assets and financial liabilities, continued

2019	Amortized cost	Fair value through OCI	Manda-torily at fair value thr. P/L	Total
Financial assets				
Loans				
Cash and balances with Central Bank	95,717	-	-	95,717
Loans to credit institutions	17,947	-	-	17,947
Loans to customers	773,955	-	-	773,955
Loans	887,619	-	-	887,619
Bonds and debt instruments				
Listed	-	47,698	16,479	64,177
Unlisted	-	1,196	501	1,697
Bonds and debt instruments	-	48,894	16,980	65,874
Shares and equity instruments with variable income				
Listed	-	-	9,632	9,632
Unlisted	-	-	7,417	7,417
Bond funds with variable income, unlisted	-	-	4,551	4,551
Shares and equity instruments with variable income	-	-	21,600	21,600
Derivatives				
OTC derivatives	-	-	5,001	5,001
Derivatives used for hedge accounting	-	-	1,616	1,616
Derivatives	-	-	6,617	6,617
Securities used for economic hedging				
Bonds and debt instruments, listed	-	-	10,852	10,852
Shares and equity instruments with variable income, listed	-	-	12,459	12,459
Shares and equity instruments with variable income, unlisted	-	-	4	4
Securities used for economic hedging	-	-	23,315	23,315
Other financial assets				
Accounts receivable	3,617	-	-	3,617
Other financial assets	5,058	-	-	5,058
Other financial assets	8,675	-	-	8,675
Financial assets	896,294	48,894	68,512	1,013,700
Financial liabilities				
Due to credit institutions and Central Bank	5,984	-	-	5,984
Deposits	492,916	-	-	492,916
Borrowings	304,745	-	-	304,745
Subordinated liabilities	20,083	-	-	20,083
Short position in bonds	-	-	385	385
Short position in equity	-	-	24	24
Short position in equity, used for economic hedging	-	-	107	107
Derivatives	-	-	2,054	2,054
Other financial liabilities	6,408	-	-	6,408
Financial liabilities	830,136	-	2,570	832,706

Amounts are in ISK millions

23. Financial assets and financial liabilities, continued

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

2020	FVOCI	Mandatorily FVPL	Total
Financial and insurance activities	13,840	7,298	21,138
Public sector	122,743	11,097	133,840
Corporates	1,072	1,694	2,766
Bonds and debt instruments at fair value	137,655	20,089	157,744
2019			
Financial and insurance activities	417	5,613	6,030
Public sector	41,417	7,259	48,676
Corporates	7,060	4,108	11,168
Bonds and debt instruments at fair value	48,894	16,980	65,874

The total amount of pledged bonds was ISK 8.2 billion at the end of the year (31.12.2019: ISK 6.0 billion). Pledged bonds comprised Icelandic Government Bonds and Financial Institutions 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.

24. 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.

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

2020

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	155,061	2,325	358	157,744
Shares and equity instruments with variable income	6,097	10,859	1,685	18,641
Derivatives	-	5,002	-	5,002
Derivatives used for hedge accounting	-	2,282	-	2,282
Securities used for economic hedging	43,551	31	-	43,582
Investment property	-	-	6,132	6,132
Assets at fair value	204,709	20,499	8,175	233,383
Liabilities at fair value				
Short position in bonds	40	-	-	40
Short position in bonds used for economic hedging	666	-	-	666
Short position in equity	63	-	-	63
Derivatives	-	4,471	-	4,471
Liabilities at fair value	769	4,471	-	5,240

Amounts are in ISK millions

24. Fair value hierarchy, continued

2019

Assets at fair value	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	57,196	8,650	28	65,874
Shares and equity instruments with variable income	5,169	14,876	1,555	21,600
Derivatives	-	5,001	-	5,001
Derivatives used for hedge accounting	-	1,616	-	1,616
Securities used for economic hedging	22,819	496	-	23,315
Investment property	-	-	7,120	7,120
Assets at fair value	85,184	30,639	8,703	124,526
Liabilities at fair value				
Short position in bonds	385	-	-	385
Short position in equity	24	-	-	24
Short position in equity, used for economic hedging	107	-	-	107
Derivatives	-	2,054	-	2,054
Liabilities at fair value	516	2,054	-	2,570

Transfers from Level 2 to Level 1 amounted to ISK 82 million during the year (2019: Transfers from Level 1 to Level 2 amounted to ISK 20 million).

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 23 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

24. Fair value hierarchy, continued

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

In some 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		
2020	property	Bonds	Shares	Total
Balance at the beginning of the year	7,119	28	1,555	8,702
Net fair value changes	580	9	(59)	530
Additions	17	762	196	975
Disposals	(1,584)	(441)	(7)	(2,032)
Balance at the end of the year	6,132	358	1,685	8,175
2019				
Balance at the beginning of the year	7,092	42	1,329	8,463
Net fair value changes	-	20	62	82
Additions	30	5	281	316
Disposal	(3)	(27)	(117)	(147)
Transfers out of Level 3	-	(12)	-	(12)
Balance at the end of the year	7,119	28	1,555	8,702

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

2020				
Net financial income	-	9	(59)	(50)
Other operating income	912	-	-	912
Effects recognized in the Income Statement	912	9	(59)	862
2019				
Net financial income	-	20	62	82
Effects recognized in the Income Statement	-	20	62	82

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

24. Fair value hierarchy, continued

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

2020	Carrying value	Fair value	Unrealized gain (loss)
Financial assets not carried at fair value			
Cash and balances with Central Bank	42,136	42,136	-
Loans to credit institutions	28,235	28,235	-
Loans to customers	822,941	827,252	4,311
Other financial assets	9,667	9,667	-
Financial assets not carried at fair value	902,979	907,290	4,311
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	13,031	13,031	-
Deposits	568,424	568,424	-
Borrowings	298,947	316,643	(17,696)
Subordinated liabilities	36,060	34,762	1,298
Other financial liabilities	8,011	8,011	-
Financial liabilities not carried at fair value	924,473	940,871	(16,398)

2019			
Financial assets not carried at fair value			
Cash and balances with Central Bank	95,717	95,717	-
Loans to credit institutions	17,947	17,947	-
Loans to customers	773,955	777,320	(3,365)
Other financial assets	8,675	8,675	-
Financial assets not carried at fair value	896,294	899,659	(3,365)
Financial liabilities not carried at fair value			
Due to credit institutions and Central Bank	5,984	5,984	-
Deposits	492,916	492,916	-
Borrowings	304,745	316,589	(11,844)
Subordinated liabilities	20,083	20,177	(94)
Other financial liabilities	6,408	6,408	-
Financial liabilities not carried at fair value	830,136	842,074	(11,938)

Loans to customers largely bear variable interest rates. Those loans, including corporate loans, are presented at book value as they generally have a short duration and very limited interest rate risk. Loans with fixed interest rates, 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

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

24. Fair value hierarchy, continued

Derivatives	Notional	Fair value	
2020	value	Assets	Liabilities
Forward exchange rate agreements	72,804	1,140	267
Fair value hedge of interest rate swap	137,636	2,282	-
Interest rate and exchange rate agreements	55,838	3,339	1,022
Bond swap agreements	28,617	100	275
Share swap agreements	13,445	400	2,885
Options - purchased agreements, unlisted	826	11	22
Options - purchased agreements, listed	16	12	-
Derivatives	309,182	7,284	4,471
2019			
Forward exchange rate agreements	90,121	1,196	407
Fair value hedge of interest rate swap	114,337	1,616	-
Interest rate and exchange rate agreements	65,823	2,312	1,168
Bond swap agreements	9,936	46	48
Share swap agreements	12,710	1,447	431
Derivatives	292,927	6,617	2,054

Fair value hedge of interest rate swap

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, with identical cash flows to the borrowings. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate euro bonds, see Note 32, arising from changes in interest rates. On 1 January 2018 the Group adopted 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 57.

	Notional	Maturity	Fair value		Gain (loss) on FV
2020		date	Assets	Liabilities	changes
Interest rates swaps - EUR	93,654	1-5 years	1,327	-	(304)
Interest rates swaps - EUR	31,218	6-12 months	139	-	(47)
Interest rates swaps - EUR	-	-	-	-	(45)
Interest rates swaps - USD	12,764	1-5 years	815	-	618
2019					
Interest rates swaps - EUR	108,667	1-5 years	1,608	-	457
Interest rates swaps - EUR	5,670	3-6 months	8	-	302

Hedged borrowings and subordinated liabilities	Book	Accumulated fair value		Gain (loss) on FV
2020	value	Assets	Liabilities	changes
EUR 500 million - issued 2017/18 - 5 years	31,071	113	-	48
EUR 300 million - issued 2017 - 3 years	-	-	-	(38)
EUR 300 million - issued 2018 - 3 years	44,276	-	352	264
EUR 300 million - issued 2020 - 4 years	46,655	-	-	-
USD 100 million - issued 2020 - Perpetual	13,498	-	601	(673)
Hedged borrowings and subordinated liabilities	135,500	113	953	(399)
2019				
EUR 500 million - issued 2016/18 - 5 years	67,713	157	-	(410)
EUR 300 million - issued 2017 - 3 years	5,635	33	-	(199)
EUR 300 million - issued 2018 - 3 years	41,601	-	756	(295)
Hedged borrowings	114,949	190	756	(904)

The effectiveness of each hedge is measured regularly with linear regression. The relationship between fair value changes of an interest rate swap on the one hand and a borrowing on the other hand is examined. In all cases the effectiveness is within limits, or between 83-106%.

Amounts are in ISK millions

25. 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				
2020	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	8,229	(433)	7,796	(7,074)	-	722	-	7,796
Derivatives	6,012	-	6,012	(1,167)	-	4,845	1,272	7,284
Total assets	14,241	(433)	13,808	(8,241)	-	5,567	1,272	15,080
2019								
Reverse repurchase agreements	6,539	(44)	6,495	(5,921)	-	574	-	6,495
Derivatives	4,601	-	4,601	(713)	-	3,888	2,016	6,617
Total assets	11,140	(44)	11,096	(6,634)	-	4,462	2,016	13,112

Financial liabilities subject to enforceable master netting arrangements and similar arrangements

	Liabilities subject to netting arrangements			Netting potential not recognized in the Balance Sheet				
2020	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	7,507	(433)	7,074	(7,074)	-	-	-	7,074
Derivatives	1,167	-	1,167	(1,167)	-	-	3,304	4,471
Total liabilities	8,674	(433)	8,241	(8,241)	-	-	3,304	11,545
2019								
Repurchase agreements	5,965	(44)	5,921	(5,921)	-	-	-	5,921
Derivatives	761	-	761	(713)	-	48	1,293	2,054
Total liabilities	6,726	(44)	6,682	(6,634)	-	48	1,293	7,975

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

26. Investments in associates

	2020	2019
Carrying amount at the beginning of the year	852	818
Acquisitions	39	18
Disposals	-	(740)
Share of profit of associates and profit from sale	-	756
Investment in associates	891	852

The Group's interest in its principal associates

	2020	2019
Audkenni hf., Borgartún 31, Reykjavík, Iceland	25.4%	25.4%
JCC ehf., Borgartún 19, Reykjavík, Iceland	33.3%	33.3%
Reiknistofa bankanna hf., Katrínartún 2, Reykjavík, Iceland	20.0%	20.0%
220 Fjördur ehf., Fjardargata 13-15, Hafnarfjördur, Iceland	37.4%	37.4%
SER eignarhaldsfélag ehf., Borgartún 19, Reykjavík	35.3%	35.3%

Amounts are in ISK millions

27. Intangible assets

Intangible assets comprise the 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 acquired (i.e. software licenses) and expenses of implementation.

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

Customer relationships and related agreements are connected to business relationships and agreements which the Bank acquired in subsidiaries. The asset is based on the assumption that business relationships and agreements generate regular payments and earnings to the relevant business segments. The lifetime of these agreements is based on the experience of the Group and the industry. As a result, these 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 and bringing the software into service. Expenditure on internally developed software is recognized as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and when it can reliably measure the costs to complete the development. The capitalized costs of internally developed software include external expenses directly attributable to developing the software and salary and salary related expenses of implementation of core systems. Capitalized costs of software are amortized over its useful life. Computer software licenses and internally developed software 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 6-15 years and undefined	Finite 3-10 years
Amortization method	Impairment test	Straight-line basis over 6-15 years and impairment test	Straight-line basis over 3-10 years
Internally generated or acquired	Acquired	Acquired	Acquired and internally generated

2020	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	669	2,383	727	4,588	8,367
Additions	-	-	-	1,570	1,570
Additions, capitalized salaries	-	-	-	594	594
Amortization	-	-	(60)	(782)	(842)
Intangible assets	669	2,383	667	5,970	9,689

2019	Goodwill	Infra-structure	Customer relationship and related agreements	Software	Total
Balance at the beginning of the year	669	2,383	787	2,558	6,397
Additions	-	-	-	2,291	2,291
Additions, capitalized salaries	-	-	-	459	459
Amortization	-	-	(60)	(720)	(780)
Intangible assets	669	2,383	727	4,588	8,367

Goodwill is recognized among assets in the operating segment Vördur, see Note 5.

Impairment testing

The methodology for impairment testing on the Infrastructure and Customer relationship, which is part of intangible assets, is based on discounted cash flow model which uses inputs that consider features of the business and the environment.

The model used, to determine the recoverable amount, is most sensitive to changes in the forecast earnings available to shareholders over a five-year period, the cost of equity and to changes in the growth rate. As a result of this analysis no impairment was recognized in 2020 (2019: nil).

	2020		2019	
Discount and growth rates	Discount rates	Growth rates	Discount rates	Growth rates
Asset Management operation	10.0%	2.5%	10.8%	2.5%
Insurance operation	11.0%	2.5%	12.8%	2.5%

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

28. Tax assets and tax liabilities

	2020		2019	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	3,799	-	3,461
Deferred tax	2	463	2	943
Tax assets and tax liabilities	2	4,262	2	4,404

Deferred tax assets and tax liabilities are attributable to the following:

	2020 Assets	2020 Liabilities	2019 Assets	2019 Liabilities
Foreign currency denominated assets and liabilities	26	-	2	(272)
Investment property and property and equipment	-	(542)	-	(261)
Financial assets	613	-	248	-
Other assets and liabilities	205	(325)	149	(359)
Deferred tax related to foreign exchange gain	-	(438)	-	(449)
Tax loss carry forward	-	-	1	-
	844	(1,305)	400	(1,341)
Set-off of deferred tax assets together with tax liabilities of the same taxable entities	(842)	842	(398)	398
Deferred tax assets and tax liabilities	2	(463)	2	(943)

Deferred tax assets are recognized for unused tax losses to the extent that it is probable that taxable profit will be available against which the losses can be utilized. Significant management judgement is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of future taxable profits, together with future tax planning strategies.

The Group has ISK 672 million (31.12.2019: ISK 1,899 million) of tax losses carried forward. These losses relate to subsidiaries that have a history of losses, do not expire, and may not be used to offset taxable income elsewhere in the Group. The subsidiaries neither have any taxable temporary difference nor any tax planning opportunities available that could partly support the recognition of these losses as deferred tax assets. On this basis, the Group has determined that it cannot recognize deferred tax assets on the tax losses carried forward. If the Group was able to recognize all unrecognized deferred tax assets, profit and equity would have increased by ISK 134 million (2019: ISK 380 million).

Changes in deferred tax assets and tax liabilities

	At 1 Jan.	Recognized through equity	Recognized in profit or loss	At 31 Dec.
2020				
Foreign currency denominated assets and liabilities	(270)	-	296	26
Investment property and property and equipment	(261)	-	(281)	(542)
Financial assets	248	-	365	613
Other assets and liabilities	(210)	78	12	(120)
Deferred foreign exchange differences	(449)	-	11	(438)
Tax loss carry forward	1	-	(1)	-
Change in deferred tax assets and tax liabilities	(941)	78	402	(461)
2019				
Foreign currency denominated assets and liabilities	(305)	-	35	(270)
Investment property and property and equipment	(221)	-	(40)	(261)
Financial assets	567	-	(319)	248
Other assets and liabilities	(218)	(22)	30	(210)
Deferred foreign exchange differences	(302)	-	(147)	(449)
Tax loss carry forward	100	-	(99)	1
Change in deferred tax assets and tax liabilities	(379)	(22)	(540)	(941)

29. Assets and disposal groups held for sale and associated liabilities

Assets and disposal groups held for sale	2020	2019
Valitor hf.	11,885	30,657
Stakksberg ehf.	1,580	2,711
Sólbjarg ehf.	2,323	8,676
Disposal groups held for sale	15,788	42,044
Real estate	1,019	1,553
Other assets	4	29
Assets and disposal groups held for sale	16,811	43,626

Amounts are in ISK millions

29. Assets and disposal groups held for sale and associated liabilities, cont.

Liabilities associated with disposal groups held for sale	2020	2019
Valitor hf.	14,533	22,052
Sólbjarg ehf.	1,650	6,579
Liabilities associated with disposal groups held for sale	16,183	28,631

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

Valitor hf.

Arion Bank's shareholding in the subsidiary Valitor hf. is 100%. The Bank is in the process of potentially divesting the Bank's shareholding in Valitor. The Bank is aiming for having completed the sale of Valitor within the next 12 months. In accordance with IFRS 5 Non-current assets and disposal groups held for sale, Valitor is classified as asset held for sale in these Consolidated Financial Statements.

	2020	2019
Cash and balances with Central Bank	-	9,363
Loans to credit institutions	14,127	12,563
Loans to customers	1,878	2,061
Financial instruments	-	28
Investments in associates	70	66
Intangible assets	4,534	4,720
Tax assets	422	293
Other assets	2,104	2,986
Assets	23,135	32,080
Elimination within Arion Bank Group	(11,250)	(1,423)
Valitor's contribution to the Group	11,885	30,657
Due to credit institutions and Central Bank	-	2
Financial liabilities at fair value	-	26
Tax liabilities	163	321
Other liabilities	14,369	21,712
Borrowings	96	3,500
Liabilities	14,628	25,561
Elimination within Arion Bank Group	(95)	(3,509)
Valitor's contribution to the Group	14,533	22,052
Book value of Valitor	8,507	6,519

In May 2020 Valitor sold the operations of Valitor in Denmark, Valitor A/S. The operation of Valitor A/S contributed a net loss for the years 2018 and 2019. The financial effects of the sale of the entity did not have material effects on these Consolidated Financial Statements.

Sólbjarg ehf., a subsidiary of Eignabjarg ehf.

On 20 June 2019 Arion Bank acquired all shares in TravelCo hf. and its subsidiaries (hereafter "TravelCo") following an enforcement of pledges. TravelCo was established following the collapse of Primera Air ehf. and Primera Travel Group hf. with the purpose of owning and operating tour operators in Scandinavia and Iceland. Sólbjarg ehf (hereafter “Sólbjarg”) is the holding company of the TravelCo group in the beneficial ownership of Arion Bank. Arion Bank completed the sale of Terra Nova Sól ehf., a subsidiary of Sólbjarg, in Q1 2020. The travel industry was hit hard by the Covid-19 pandemic and suffered a total loss of income. The Scandinavian operations entered therefore into financial restructuring late 2020 and then bankruptcy proceedings with undergoing assets sales. Bravo Tours 1998 A/S was established and is now in 59.4% ownership of Sólbjarg and 40.6% under Danish ownership. Heimsferdir ehf., an Icelandic travel agency, is now under the direct ownership of Sólbjarg 100%. A sales and purchase agreement was signed with Ferðaskrifstofa Íslands ehf. in December 2020 for the sale all operations of Heimsferðir ehf. The sale is subject to the approval of the Icelandic Competition Authorities. Sólbjarg will be a minority shareholder in Ferðaskrifstofa Íslands ehf. if the sale will materialize. Sólbjarg’s subsidiaries are classified as held for sale in accordance with IFRS 5.

Amounts are in ISK millions

29. Assets and disposal groups held for sale and associated liabilities, continued

Stakksberg ehf., a subsidiary of Eignabjarg ehf.

In January 2018 United Silicon was declared bankrupt following serious operational problems which resulted in its operating license being temporarily suspended. 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. The assets of the silicon plant are currently managed by Stakksberg ehf., which is held by the Bank through the subsidiary Eignabjarg ehf. Stakksberg ehf. has, since the transfer of the assets from United Silicon, worked to reduce uncertainties surrounding the recommissioning of the silicon plant, with measures including the securing of 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. Stakksberg ehf. is currently engaged in the final stages of concluding a new environmental impact assessment for the plant. The Bank's objective is to divest Stakksberg ehf. based on this preparatory work. Stakksberg is therefore classified as held for sale in accordance with IFRS 5.

30. Other assets

	2020	2019
Property and equipment	4,792	5,243
Right of use asset	754	902
Accounts receivable	5,222	3,617
Unsettled securities trading	3,888	3,178
Investment for life assurance policyholders where risk is held by policyholder	1,141	1,008
Sundry assets	2,821	2,916
Other assets	18,618	16,864

Property and equipment	Real estate	Equip-ment	Total 2020	Total 2019
Gross carrying amount at the beginning of the year	5,784	6,540	12,324	12,465
Additions	-	1,115	1,115	498
Disposals	(1,176)	(190)	(1,366)	(638)
Gross carrying amount at the end of the year	4,608	7,465	12,073	12,325
Accumulated depreciation at the beginning of the year	(2,113)	(4,968)	(7,081)	(6,668)
Depreciation	(121)	(496)	(617)	(638)
Disposals	275	142	417	224
Accumulated depreciation at the end of the year	(1,959)	(5,322)	(7,281)	(7,082)
Property and equipment	2,649	2,143	4,792	5,243

The official real estate value (Registers Iceland) amounted to ISK 4,561 million at the end of the year (2019: ISK 6,024 million) and the insurance value amounts to ISK 8,856 million (2019: ISK 11,038 million).

Right-of-use asset	2020	2019
Balance at the beginning of the year	902	984
New lease agreements	9	20
Lease agreements terminated	(42)	-
Indexation	18	26
Depreciation	(133)	(128)
Right-of-use asset	754	902

Right-of-use asset consists of real estates for own use.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

31. Other liabilities

	2020	2019
Accounts payable	850	654
Unsettled securities trading	272	365
Depositors' and Investors' Guarantee Fund	131	167
Technical provision	16,152	14,709
Technical provision for life assurance policyholders were investment risk is held by policyholder	1,141	1,008
Withholding tax	790	1,492
Bank levy	1,301	2,984
Accrued expenses	2,888	3,441
Prepaid income	1,516	1,573
Impairment of off-balance items	1,062	481
Lease liability	787	914
Sundry liabilities	5,824	4,909
Other liabilities	32,714	32,697

Technical provision	Technical provision	Reinsurers' share	Total 2020	Technical provision	Reinsurers' share	Total 2019
Claims reported and loss adjustment expenses	8,428	(149)	8,279	7,742	(221)	7,521
Claims incurred but not reported	1,691	(82)	1,609	1,426	(82)	1,344
Claims outstanding	10,119	(231)	9,888	9,168	(303)	8,865
Provision for unearned premiums	6,033	(7)	6,026	5,541	(4)	5,537
Own technical provision	16,152	(238)	15,914	14,709	(307)	14,402

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.

Lease liability	2020	2019
Balance at the beginning of the year	914	984
New lease agreements	9	20
Lease agreements terminated	(43)	-
Indexation	25	21
Interest expense	42	45
Lease payments	(160)	(156)
Lease liability	787	914

Amounts are in ISK millions

32. Borrowings

Currency, original nominal value	First issued	Maturity	Maturity type	Terms of interest	2020	2019
ARION CBI 21, ISK 10,220 million	2014	2021	At maturity	Fixed, CPI linked, 3.50%	10,576	10,176
ARION CB 22, ISK 28,720 million	2015	2022	At maturity	Fixed, 6.50%	28,443	28,264
ARION CB 24 ISK 20,180 million	2019	2024	At maturity	Fixed, 6.00%	16,857	16,060
ARION CBI 25, ISK 37,940 million	2017	2025	At maturity	Fixed, CPI linked, 3.00%	41,576	40,213
ARION CBI 26 ISK 15,460 million	2019	2026	At maturity	Fixed, CPI linked, 2.00%	17,030	12,320
ARION CBI 29, ISK 25,220 million	2014	2029	At maturity	Fixed, CPI linked, 3.50%	28,561	27,689
ARION CBI 48, ISK 11,680 million	2018	2048	Amortizing	Fixed, CPI linked, 2.50%	10,721	10,647
Statutory covered bonds					153,764	145,369
NOK 800 million	2015	2020	At maturity	Floating, NIBOR +2.95%	-	11,143
NOK 320 million	2016	2020	At maturity	Floating, NIBOR +1.95%	-	4,439
EUR 300 million *	2017	2020	At maturity	Fixed, 0.75%	-	5,635
SEK 300 million	2017	2020	At maturity	Floating, 3 month STIBOR +1.35%	-	2,598
SEK 250 million	2017	2020	At maturity	Floating, 3 month STIBOR +0.75%	-	3,241
EUR 500 million *	2016	2021	At maturity	Fixed, 1.625%	31,071	67,713
EUR 13 million	2019	2021	At maturity	Floating, 3. EURIBOR +0.58%	2,030	1,765
NOK 750 million	2019	2022	At maturity	Floating, NIBOR +1.82%	11,207	10,382
SEK 150 million	2019	2022	At maturity	Floating, 3 month STIBOR +1.33%	2,338	1,949
NOK 250 million	2017	2023	At maturity	Fixed, 3.02%	3,798	3,512
EUR 300 million *	2018	2023	At maturity	Fixed, 1.00%	44,276	41,601
EUR 300 million *	2020	2024	At maturity	Fixed, 0.625 %	46,655	-
NOK 250 million	2017	2027	At maturity	Fixed, 3.40%	3,808	3,521
Senior unsecured bonds					145,183	157,499
Bills issued					-	1,680
Other borrowings					-	197
Other borrowings / bills					-	1,877
Borrowings					298,947	304,745

* 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 24.

The book value of listed bonds was ISK 299 billion at the end of the year (31.12.2019: ISK 303 billion). The market value of those bonds was ISK 317 billion (31.12.2019: ISK 315 billion). The Group repurchased ISK 54 billion own debts during the year (31.12.2019: ISK 39 billion) with a net loss of ISK 700 million recognised in the Income Statement (2019: ISK 300 million).

33. Subordinated liabilities

Currency, original nominal value	Issued	Maturity	First call date	Terms of interest	2020	2019
SEK 500 million	2018	2028	22 Nov '23	Floating, 3 month STIBOR +3.10% .	7,765	6,472
NOK 300 million	2019	2029	9 Jul '24	Floating, NIBOR +3.65%	4,508	4,183
SEK 225 million	2019	2029	20 Dec '24	Floating, 3 month STIBOR +3.70% .	3,500	2,918
ARION T2I 30 ISK 4.800 million	2019	2030	4 Jan '25	Fixed, CPI linked, 3.875%	5,088	4,913
ARION T2 30 ISK 880 million	2019	2030	4 Jan '25	Fixed, 6.75%	907	907
EUR 5 million	2019	2031	6 Mar '26	Fixed, 3.24%	794	690
Tier 2 subordinated liabilities					22,562	20,083
ARION AT1 USD 100 million	2020	Perpetual	26 Feb '25	Fixed, 6.25%	13,498	-
Additional Tier 1 subordinated liabilities					13,498	-
Subordinated liabilities					36,060	20,083

Additional Tier 1 and Tier 2 subordinated liabilities are eligible as regulatory capital under the Icelandic Financial Undertakings Act No. 161/2002.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

34. Pledged assets

Pledged assets against liabilities	2020	2019
Assets, pledged as collateral against borrowings	228,358	186,902
Assets, pledged as collateral against loans from credit institutions and short positions	8,150	6,023
Pledged assets against liabilities	236,508	192,925

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 228 billion at the end of the year (31.12.2019: ISK 187 billion). Pledged loans comprised mortgage loans to individuals. The book value of those borrowings was ISK 154 billion at the end of the year (31.12.2019: ISK 145 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.

The Group has issued covered bonds amounting to ISK 30 billion that can be used for repo borrowings at the Central Bank of Iceland or sold if market conditions are favorable. Pledged loans are thus higher than the covered bonds stated in the Consolidated Statement of Financial Position.

35. Equity

Share capital and share premium

According to the Bank's Articles of Association, total share capital amounts to ISK 1,730 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.

	Share capital	Share premium	Total 2020	Share capital	Share premium	Total 2019
Shares outstanding at the beginning of the year	1,773	53,942	55,715	1,814	57,196	59,010
Purchase of treasury stock	(54)	(4,326)	(4,380)	(41)	(3,242)	(3,283)
Employees stock grant	-	(4)	(4)	-	(12)	(12)
Shares outstanding	1,719	49,612	51,331	1,773	53,942	55,715
Own shares at year-end	11			41		
- as proportion of issued share capital	0.69%			2.29%		

In 2019 the Board of Directors authorized the Bank to initiate a share buy-back program in Iceland and Sweden (the Program) to purchase own shares, which is in line with the authorization granted by the AGM on 20 March 2019. The purpose of the Program was to reduce the Bank's share capital (in line with the Bank's dividend policy). When the Program was initiated on 31 October 2019, the Bank was authorized to purchase up to 59 million own shares in total under the Program, corresponding to 3.25% of the issued share capital, or for up to ISK 4.5 billion at market value. In January 2020 the FSA approved the buy-back of an additional 41 million own shares or for up to ISK 3.5 billion at market value, bringing the total amount of the share Program to 100 million shares or ISK 8.0 billion at market value. The Program continued until the AGM in March 2020.

At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020. The company's share capital was reduced from ISK 1,814 million to ISK 1,730 million at nominal value, divided into an equal number of shares and with one vote attached to each share.

According to a decision made by the Board of Directors, own shares were allocated to employees in connection with the Bank's IPO and listing in 2018. In total approximately 4 million shares were allocated to employees at ISK 75 per share, a total of ISK 295 million. In accordance with the employees' stock grant programme, an employee who resigned within the vesting period of two years, returned the shares to the Bank. The vesting period ended in June 2020.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

Other information

36. Shareholders of Arion Bank

	03.02.2021	31.12.2020	31.12.2019
Taconic Capital Advisors	16.28%	23.22%	23.53%
Gildi lífeyrissjódur	9.92%	9.92%	8.79%
Lífeyrissjódur verzlunarmanna	7.81%	7.46%	3.67%
Sculptor Capital Management	2.94%	6.12%	9.53%
Lífeyrissjódur starfsmanna ríkisins	7.34%	6.03%	3.47%
Stodir hf.	4.99%	4.99%	4.96%
Stapi lífeyrissjódur	3.00%	2.92%	1.89%
Birta lífeyrissjódur	3.07%	2.83%	1.32%
Frjálsi lífeyrissjódurinn	2.73%	2.73%	2.18%
Stefnir rekstrarfélag hf.	2.55%	2.13%	2.46%
Eaton Vance funds	1.37%	2.11%	3.23%
Íslandsbanki hf.	2.26%	1.54%	1.00%
Hvalur hf.	2.13%	1.52%	1.45%
Lífsverk Pension fund	1.50%	1.37%	0.77%
MainFirst Bank AG	1.14%	1.14%	1.09%
Lífeyrissjódur Vestmannaeyja	1.28%	1.13%	0.52%
Lansdowne partners	0.21%	1.12%	5.02%
Goldman Sachs International	0.00%	0.00%	3.72%
Arion banki hf.	0.69%	0.69%	2.27%
Kvika asset management	1.26%	0.87%	1.10%
Other shareholders with less than 1% shareholding	27.53%	20.17%	18.04%
	100.0%	100.0%	100.0%

Total number of shareholders in Arion Bank was around 7,400 at the end of the year, compared with around 6,500 at the beginning of the year.

At the end of the year the Bank's employees held a shareholding of 0.53% in Arion Bank (31.12.2019: 0.43%).

At the AGM in March 2020 a motion was passed to reduce the company's share capital by ISK 84 million at nominal value, by cancelling the company's own shares. The reduction took place in May 2020. Shareholdings changed accordingly.

At the end of January 2021 the Bank's largest shareholder, Taconic Capital Advisors, sold approximately 7% in the Bank to a diverse group of investors, mainly Icelandic pension funds, fund managers and other domestic investors.

37. Legal matters

The Group has formal controls and policies in place 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 year, the Group had several unresolved legal claims.

Contingent liabilities

Legal proceedings regarding damages

In a lawsuit brought in June 2013, Kortathjónustan hf. claimed damages from Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., Borgun hf. and the Bank's subsidiary Valitor hf. in the amount of ISK 1.2 billion plus interest, as a result of damage Kortathjónustan hf. contended the five parties caused the company due to violations of the Competition Act. In June 2017 the Supreme Court dismissed the case on procedural grounds. Since then Kortatjónustan and subsequently its largest shareholder EC-Clear have tried to initiate four lawsuits against the same defendants which have all been dismissed, last one in December 2019. In April 2020 EC-Clear has once again brought the same matter of dispute, claiming damages in the amount of ISK 922 million plus interest, against the same defendants. For the fifth time, the case has been dismissed by the District Court, again for procedural grounds. The dismissal has yet again been appealed by EC-Clear to the Landsréttur Appeal Court. The parties have submitted their statements and are waiting for ruling to take place. Should the defendants be found liable for damages, they would be jointly responsible. Therefore, the Bank has not made any provision.

Amounts are in ISK millions

37. Legal matters, cont.

Administrative fine from Central Bank of Iceland

On 17 July 2020 the Financial Supervisory Authority of the Central Bank of Iceland (FSA) published its decision to impose an administrative fine on Arion Bank of ISK 87.7 million due to the Bank´s alleged breach of obligation to disclose insider information in a timely manner. The decision has been published on FSA´s website. Arion Bank paid the fine but filed a claim to the district court of Reykjavik in October 2020 demanding that FSA´s decision will be annulled. A statement by FSA was submitted in the case in November 2020 but the principal proceedings in the case have not yet taken place before the District Court.

Legal matters concluded

Legal proceedings regarding damages

The former chairman of the Board of BM Vallá hf., together with Lindarflöt ehf., filed two cases against the Bank with a claim for damages in the amount of more than ISK 4 billion, plus interest. The plaintiffs maintained 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. The plaintiffs appealed the judgment Landsréttur the Appeal Court annulled the judgment of the District Court and ordered the District Court to hear the case again. The District Court then acquitted the Bank of all claims with a judgment in September 2018. The plaintiffs appealed the judgment to the Appeal Court, which in December 2019 confirmed the District Court's judgment. An appeal to the Supreme Court was then rejected. In the beginning of May 2020 the plaintiff notified the Court that it had discontinued the second case and thereby that case was dismissed.

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 transferred the assets to the Bank. The trustee in the estate approved the Bank's secured claims but two unsecured creditors disputed the Bank's lien on the assets of United Silicon in the bankruptcy proceedings. The trustee in the bankruptcy referred the dispute to the District Court of Reykjanes. The Bank examined the disputes and rejected them all. In January 2020 the dispute was settled between the parties with minor effect on the Bank's value of the assets.

38. Events after the reporting period

No event has arisen after the reporting year and up to the approval of these Consolidated Financial Statements that require additional disclosures.

Off balance sheet information

39. Commitments

Financial guarantees, unused credit facilities and undrawn loan commitments	2020	2019
Financial guarantees	20,857	15,097
Unused overdrafts	49,164	44,923
Undrawn loan commitments	64,055	54,101
Financial guarantees, unused credit facilities and undrawn loan commitments	134,076	114,121

40. Assets under management and under custody

Assets under management	1,130,978	1,013,101
Assets under custody	934,967	1,370,946

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.

Related party

41. Related party

The Group has a related party relationship with an entity with an influence over the Group as the largest shareholder of Arion Bank, which is at the end of the year Taconic Capital.

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.

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

2020	Assets	Liabilities	Net balance
Board of Directors and key Management personnel	172	(575)	(403)
Associates and other related parties	-	(112)	(112)
Balances with related parties	172	(687)	(515)

2019			
Board of Directors and key Management personnel	184	(252)	(68)
Associates and other related parties	-	(59)	(59)
Balances with related parties	184	(311)	(127)

Transactions with related parties

2020	Interest income	Interest expense	Other income	Other expense
Board of Directors and key Management personnel	8	(9)	19	(408)
Associates and other related parties	-	-	-	(1,565)
Transactions with related parties	8	(9)	19	(1,973)

2019				
Board of Directors and key Management personnel	6	(17)	17	(347)
Associates and other related parties	-	-	28	(1,110)
Transactions with related parties	6	(17)	45	(1,457)

Amounts are in ISK millions

Risk management disclosures

The Group faces various risks arising from its day to day operations and is currently facing a unique set of risks arising from the impact of the Covid-19 pandemic on the Group's operations and its customers. Managing risk is 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 and this process enables the Group to ensure that the exposure to risk remains within acceptable levels.

The Board of Directors is ultimately responsible for the Group's risk management framework and for ensuring that satisfactory risk policies and governance for controlling the Group's risk exposure are in place. The Board allocates risk management of subsidiaries to the relevant subsidiary. For the parent company (the Bank) the Board sets its risk appetite, which is translated into exposure limits and targets monitored by the Bank's Risk Management division.

The Chief Executive Officer (CEO) is responsible for sustaining an effective risk management framework, processes and controls as well as maintaining a high level of risk awareness among the employees, making risk everyone's business.

The Bank operates several committees to manage risk. The Board Risk Committee (BRIC) is responsible for supervising the Bank's risk management framework, risk appetite and the internal capital and liquidity adequacy assessment processes (ICAAP/ILAAP). The Board Credit Committee (BCC) is the Bank's supreme authority in matters relating to credit risk exposures, including investments and underwriting activities. On the management level the CEO has established four primary risk committees. The Asset and Liability Committee (ALCO) is responsible for managing asset-liability mismatches, liquidity and funding risk, market risk, capital adequacy, and decides on underwriting and investment exposures. The Operational Risk Committee (ORCO) is responsible for managing operational risk, which includes information security, financial crimes, regulatory compliance and data management. The Arion Credit Committee (ACC) administers the Bank's credit rules and decides on the origination of credit while the Arion Composition and Debt Cancellation Committee (ADC) is the principal authority for debt cancellation, debt restructuring and composition agreements. ACC and ADC operate within limits set by the BCC.

The Bank's Internal Audit conducts independent reviews of the Bank's and several subsidiaries' operations, risk management framework, processes and measurements. Internal Audit discusses its results with management and reports its findings and recommendations to the Board Audit Committee (BAC).

The Bank‘s Compliance function is headed by the Compliance Officer. It is independent and centralized and reports directly to the CEO. The Compliance function manages the Bank‘s compliance risk, including risk relating to data protection, and the Bank‘s financial crime risk.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO. The division is divided into three units: Risk Analysis, which is responsible for the quantification of risk on a portfolio level, including risk modeling and reporting; Risk Monitoring and Framework, which facilitates and monitors the management of risk and controls in the first line of defense; and Credit Analysis, which supports the Bank's credit transaction process and participates in credit decisions. The Bank's Risk Officer for Security and Data, and the Bank's Risk Officer for Pension Funds are part of the Risk Management division.

Arion Bank is a small bank in international context, which is classified as systemically important in Iceland. The Group operates in a small economy which is subject to sectoral concentration, fluctuations in capital flows, and exchange rate volatility. The Group’s most significant risks are credit risk, concentration risk, liquidity risk, interest rate risk, cyber risk, third party risk and business risk. These risk factors are to the largest extent encountered within the parent company. Through the Bank's subsidiaries, the Group bears risk arising from insurance activities, card payment solutions and fund management. Operational risk is the predominant risk for the latter two.

Further information on risk management and capital adequacy is provided in the Pillar 3 Risk Disclosures for 2020. The Pillar 3 Risk Disclosures 2020 will be published in conjunction with the Financial Statements and be available on the Bank's website, www.arionbanki.is. The Pillar 3 Risk Disclosures are not subject to external audit.

42. 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 derivatives, 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 groups of connected clients.

Exposure to credit risk

The following table shows the maximum exposure to credit risk for the components of the 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 based 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. The quality of collateral is evaluated in the lending process with regards to specialization, location, age and condition and possibilities for reuse.

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 values are capped by the related exposure amount.

42. 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

		Collateral				
2020	Maximum exposure	Cash and securities	Real estate	Vessels	Other collateral	Total collateral
Cash and balances with Central Bank	42,136	-	-	-	-	-
Loans to credit institutions	28,235	-	-	-	-	-
Loans to customers at amortized cost	822,941	19,233	599,938	43,338	82,881	745,390
Individuals	*433,336*	*52*	*393,680*	*8*	*12,335*	*406,075*
Corporates	*389,605*	*19,181*	*206,258*	*43,330*	*70,546*	*339,315*
Real estate activities and construction	*127,888*	*273*	*110,453*	*65*	*2,912*	*113,703*
Fishing industry	*81,582*	*244*	*13,655*	*41,206*	*25,665*	*80,770*
Information and communication technology	*20,810*	*44*	*5,184*	-	*4,693*	*9,921*
Wholesale and retail trade	*51,599*	*274*	*38,600*	*25*	*10,220*	*49,119*
Financial and insurance activities	*35,749*	*18,295*	*3,267*	-	*9,606*	*31,168*
Industry, energy and manufacturing	*31,193*	*14*	*16,214*	-	*12,520*	*28,748*
Transportation	*12,740*	*1*	*744*	*1,875*	*2,340*	*4,960*
Services	*13,175*	*33*	*8,615*	*152*	*1,998*	*10,798*
Public sector	*6,786*	*3*	*2,103*	*7*	*228*	*2,341*
Agriculture and forestry	*8,083*	-	*7,423*	-	*364*	*7,787*
Other assets with credit risk	9,667	-	-	-	-	-
Financial guarantees	20,857	6,200	6,255	35	2,374	14,864
Undrawn loan commitments and unused overdrafts	113,219	-	-	-	-	-
Fair value through OCI	137,655	-	-	-	-	-
Government bonds	*122,743*	-	-	-	-	-
Corporate and finance bonds	*14,912*	-	-	-	-	-
Balance at the end of the year	1,174,710	25,433	606,193	43,373	85,255	760,254

2019	Maximum exposure	Cash and securities	Real estate	Vessels	Other collateral	Total collateral
Cash and balances with Central Bank	95,717	-	-	-	-	-
Loans to credit institutions	17,947	-	-	-	-	-
Loans to customers at amortized cost	773,955	20,792	544,723	54,601	73,091	693,207
Individuals	*368,569*	*198*	*328,243*	*13*	*10,996*	*339,450*
Corporates	*405,386*	*20,594*	*216,480*	*54,588*	*62,095*	*353,757*
Real estate activities and construction	*129,856*	*1,972*	*113,465*	*55*	*8,022*	*123,514*
Fishing industry	*82,941*	*17*	*12,365*	*54,121*	*9,946*	*76,449*
Information and communication technology	*19,102*	*375*	*3,529*	-	*4,308*	*8,212*
Wholesale and retail trade	*54,989*	*375*	*32,508*	*7*	*15,980*	*48,870*
Financial and insurance activities	*33,669*	*17,726*	*7,254*	-	*7,622*	*32,602*
Industry, energy and manufacturing	*39,909*	*60*	*28,183*	-	*6,711*	*34,954*
Transportation	*11,066*	-	*1,048*	*313*	*3,285*	*4,646*
Services	*17,580*	*61*	*9,137*	*92*	*5,669*	*14,959*
Public sector	*8,617*	*4*	*2,194*	-	*289*	*2,487*
Agriculture and forestry	*7,657*	*4*	*6,797*	-	*263*	*7,064*
Other assets with credit risk	8,675	-	-	-	-	-
Financial guarantees	15,097	2,232	6,322	1,403	2,262	12,219
Undrawn loan commitments and unused overdrafts	99,024	-	-	-	-	-
Fair value through OCI	48,894	-	-	-	-	-
Government bonds	*41,417*	-	-	-	-	-
Corporate and finance bonds	*7,477*	-	-	-	-	-
Balance at the end of the year	1,059,309	23,024	551,045	56,004	75,353	705,426

Amounts are in ISK millions

42. 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 valuation is based on the official valuation of the Icelandic Property Registry.

	2020		2019	
	Gross carrying amount	Thereof credit impaired	Gross carrying amount	Thereof credit impaired
Less than 50%	119,846	1,154	119,734	1,283
50-70%	176,986	2,175	130,257	2,546
70-90%	87,941	989	63,099	1,131
90-100%	10,031	213	7,369	170
100-110%	2,981	44	2,658	60
More than 110%	12,922	731	10,873	698
Not classified	22	-	47	-
Balance at the end of the year	410,729	5,306	334,037	5,888

Collateral for financial assets in stage 3

At the end of the year the gross carrying amount of assets in stage 3 are ISK 21,606 million (31.12.2019: ISK 20,155 million) with ISK 16,097 million in collateral (31.12.2019: ISK 13,618 million), thereof ISK 14,790 million in real estates (31.12.2019: 11,791 million).

Collateral repossessed

During the year the Group took possession of assets due to foreclosures. The total value of real estate the Group took possession of during the year and still holds at the end of the year is ISK 330 million (31.12.2019: ISK 501 million) and ISK 4 million in other assets (31.12.2019: ISK 9 million). The assets are held for sale, see Note 29.

Large exposures

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 has one large exposure at the end of the year, totaling ISK 20.9 billion (10.4% of eligible capital) before taking into account eligible credit risk mitigation (31.12.2019: two large exposures, totaling ISK 36.8 billion). The total exposure is ISK 20.7 billion (10.3% of eligible capital) after taking into account eligible credit risk mitigation.

Credit quality

The Group uses internal credit ratings and external credit ratings, if available, to monitor credit risk. The Group's internal credit rating system rates customers through application of statistical models based on a variety of information that has been determined to be predictive of default. This includes demographic, behavioral, financial and economic data, coupled with qualitative expert judgment for large corporate exposures. Six exposure type models rate individuals' exposures – mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans. The models are updated at least annually and recalibrated with current data with the aim of maintaining their predictive power. Year-on-year changes in risk classification of loans may in part be due to model refinement. External ratings are primarily used for marketable securities and loans to credit institutions. For further information on the rating scales used, see Note 56.

The following tables 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 impairment stage. The gross carrying amount net of loss allowance is 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.

Amounts are in ISK millions

42. Credit risk, continued

Credit quality profile by rating class

2020	Cash and balances with CB	Loans to credit institutions	Financial instruments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	42,136	21,238	137,667
Non-investment grade	-	7,098	-
Gross carrying amount	42,136	28,336	137,667
Loss allowance	-	(101)	(12)
Book value	42,136	28,235	137,655

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 (Grades AAA to BBB-)	422,053	2,300	-	40	424,393
Risk class 2 (Grades BB+ to BB-)	174,857	28,364	-	54	203,275
Risk class 3 (Grades B+ to B-)	72,459	57,330	-	55	129,844
Risk class 4 (Grades CCC+ to CCC-)	11,243	41,289	-	98	52,630
Risk class 5 (DD)	-	-	21,297	310	21,607
Unrated	2,641	608	-	-	3,249
Gross carrying amount	683,253	129,891	21,297	557	834,998
Loss allowance	(1,844)	(3,305)	(6,824)	(84)	(12,057)
Book value	681,409	126,586	14,473	473	822,941
Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	317,898	1,499	-	40	319,437
Risk class 2 (Grades BB+ to BB-)	75,261	6,865	-	54	82,180
Risk class 3 (Grades B+ to B-)	16,611	4,206	-	55	20,872
Risk class 4 (Grades CCC+ to CCC-)	2,920	4,734	-	98	7,752
Risk class 5 (DD)	-	-	5,149	310	5,459
Unrated	109	2	-	-	111
Gross carrying amount	412,799	17,306	5,149	557	435,811
Loss allowance	(807)	(395)	(1,189)	(84)	(2,475)
Book value	411,992	16,911	3,960	473	433,336
Loans to customers - Companies and sovereign					
Risk class 0 to 1 (Grades AAA to BBB-)	104,155	801	-	-	104,956
Risk class 2 (Grades BB+ to BB-)	99,596	21,499	-	-	121,095
Risk class 3 (Grades B+ to B-)	55,848	53,124	-	-	108,972
Risk class 4 (Grades CCC+ to CCC-)	8,323	36,555	-	-	44,878
Risk class 5 (DD)	-	-	16,148	-	16,148
Unrated	2,532	606	-	-	3,138
Gross carrying amount	270,454	112,585	16,148	-	399,187
Loss allowance	(1,037)	(2,910)	(5,635)	-	(9,582)
Book value	269,417	109,675	10,513	-	389,605
Loan commitments, guarantees and unused credit facilities					
Risk class 0 to 1 (Grades AAA to BBB-)	62,426	590	-	-	63,016
Risk class 2 to 4 (Grades BB+ to CCC-)	43,550	17,530	1,435	-	62,515
Unrated	8,543	2	-	-	8,545
Gross carrying amount	114,519	18,122	1,435	-	134,076
Loss allowance	(239)	(577)	(171)	-	(987)
Book value	114,280	17,545	1,264	-	133,089

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

42. Credit risk, continued

2019	Cash and balances with CB	Loans to credit institutions	Financial instru-ments at FVOCI
Loans to credit institutions, securities and cash			
Investment grade	95,717	16,099	48,900
Non-investment grade	-	1,864	-
Gross carrying amount	95,717	17,963	48,900
Loss allowance	-	(16)	(6)
Book value	95,717	17,947	48,894

Loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Risk class 0 to 1 - (Grades AAA to BBB-)	369,623	981	-	-	370,604
Risk class 2 - (Grades BB+ to BB-)	196,133	35,291	-	81	231,505
Risk class 3 - (Grades B+ to B-)	94,515	37,100	-	39	131,654
Risk class 4 - (Grades CCC+ to CCC-)	11,669	15,828	-	114	27,611
Risk class 5 - (DD)	2	-	20,158	503	20,663
Unrated	661	426	2	-	1,089
Gross carrying amount	672,603	89,626	20,160	737	783,126
Loss allowance	(974)	(921)	(7,067)	(209)	(9,171)
Book value	671,629	88,705	13,093	528	773,955
Loans to customers - Individuals					
Risk class 0 to 1 (Grades AAA to BBB-)	272,967	723	-	-	273,690
Risk class 2 (Grades BB+ to BB-)	60,165	2,257	-	81	62,503
Risk class 3 (Grades B+ to B-)	13,882	3,125	-	39	17,046
Risk class 4 (Grades CCC+ to CCC-)	4,156	6,573	-	114	10,843
Risk class 5 (DD)	-	-	6,450	503	6,953
Unrated	25	54	2	-	81
Gross carrying amount	351,195	12,732	6,452	737	371,116
Loss allowance	(418)	(319)	(1,601)	(209)	(2,547)
Book value	350,777	12,413	4,851	528	368,569
Loans to customers - Companies and sovereign					
Risk class 0 to 1 (Grades AAA to BBB-)	96,656	258	-	-	96,914
Risk class 2 (Grades BB+ to BB-)	135,968	33,034	-	-	169,002
Risk class 3 (Grades B+ to B-)	80,633	33,975	-	-	114,608
Risk class 4 (Grades CCC+ to CCC-)	7,513	9,255	-	-	16,768
Risk class 5 (DD)	2	-	13,708	-	13,710
Unrated	636	372	-	-	1,008
Gross carrying amount	321,408	76,894	13,708	-	412,010
Loss allowance	(556)	(602)	(5,466)	-	(6,624)
Book value	320,852	76,292	8,242	-	405,386
Loan commitments, guarantees and unused credit facilities					
Risk class 0 to 1 - (Grades AAA to BBB-)	53,650	1	-	-	53,651
Risk class 2 to 4 - (Grades BB+ to CCC-)	43,205	8,349	1,790	-	53,344
Unrated	5,688	1,438	-	-	7,126
Gross carrying amount	102,543	9,788	1,790	-	114,121
Loss allowance	(165)	(244)	(73)	-	(482)
Book value	102,378	9,544	1,717	-	113,639

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

42. Credit risk, continued

Sector split, gross carrying value against loss allowance

2020	Stage 1 Gross Carrying amount	Stage 1 Loss allowance	Stage 2 Gross Carrying amount	Stage 2 Loss allowance	Stage 3 Gross Carrying amount	Stage 3 Loss allowance	Total Loss allowance	Book value
Loans to credit instit., securities & cash ...	208,139	(113)	-	-	-	-	(113)	208,026
Loans to individuals	412,799	(807)	17,554	(395)	5,458	(1,273)	(2,475)	433,336
Mortgage	*360,964*	*(365)*	*13,833*	*(141)*	*3,756*	*(174)*	*(680)*	*377,873*
Other	*51,835*	*(442)*	*3,721*	*(254)*	*1,702*	*(1,099)*	*(1,795)*	*55,463*
Loans to corporates and sovereign	270,454	(1,037)	112,585	(2,910)	16,148	(5,635)	(9,582)	389,605
Real estate activities and construction .	*78,573*	*(376)*	*49,366*	*(576)*	*1,500*	*(599)*	*(1,551)*	*127,888*
Fishing industry	*73,520*	*(232)*	*7,832*	*(9)*	*675*	*(204)*	*(445)*	*81,582*
Information and communication technolo	*20,131*	*(31)*	*680*	*(66)*	*170*	*(74)*	*(171)*	*20,810*
Wholesale and retail trade	*14,917*	*(54)*	*30,925*	*(1,459)*	*8,851*	*(1,581)*	*(3,094)*	*51,599*
Financial and insurance activities	*27,835*	*(132)*	*7,791*	*(102)*	*703*	*(346)*	*(580)*	*35,749*
Industry, energy and manufacturing	*25,653*	*(70)*	*5,253*	*(132)*	*1,214*	*(725)*	*(927)*	*31,193*
Transportation	*9,910*	*(40)*	*2,846*	*(155)*	*1,166*	*(987)*	*(1,182)*	*12,740*
Services	*6,357*	*(26)*	*6,775*	*(387)*	*1,284*	*(828)*	*(1,241)*	*13,175*
Public Sector	*6,429*	*(40)*	*282*	*(4)*	*164*	*(45)*	*(89)*	*6,786*
Agriculture and forestry	*7,129*	*(36)*	*835*	*(20)*	*421*	*(246)*	*(302)*	*8,083*
Balance at the end of the year	891,392	(1,957)	130,139	(3,305)	21,606	(6,908)	(12,170)	1,030,967

2019	Stage 1 Gross Carrying amount	Stage 1 Loss allowance	Stage 2 Gross Carrying amount	Stage 2 Loss allowance	Stage 3 Gross Carrying amount	Stage 3 Loss allowance	Total Loss allowance	Book value
Loans to credit instit., securities & cash ...	162,580	(22)	-	-	-	-	(22)	162,558
Loans to individuals	351,193	(418)	12,967	(319)	6,957	(1,811)	(2,548)	368,569
Mortgage	*296,826*	*(45)*	*9,095*	*(62)*	*4,641*	*(260)*	*(367)*	*310,195*
Other	*54,367*	*(373)*	*3,872*	*(257)*	*2,316*	*(1,551)*	*(2,181)*	*58,374*
Loans to corporates	321,408	(554)	76,894	(602)	13,705	(5,464)	(6,620)	405,386
Real estate activities and construction .	*106,568*	*(152)*	*21,473*	*(58)*	*2,733*	*(708)*	*(918)*	*129,856*
Fishing industry	*54,934*	*(105)*	*27,846*	*(205)*	*1,105*	*(634)*	*(944)*	*82,941*
Information and communication technolo	*18,323*	*(35)*	*737*	*(10)*	*291*	*(204)*	*(249)*	*19,102*
Wholesale and retail trade	*43,397*	*(92)*	*9,171*	*(126)*	*3,710*	*(1,071)*	*(1,289)*	*54,989*
Financial and insurance activities	*24,792*	*(19)*	*8,867*	*(139)*	*277*	*(109)*	*(267)*	*33,669*
Industry, energy and manufacturing	*37,071*	*(23)*	*2,131*	*(19)*	*1,218*	*(469)*	*(511)*	*39,909*
Transportation	*9,259*	*(27)*	*1,252*	*(13)*	*1,162*	*(567)*	*(607)*	*11,066*
Services	*13,138*	*(35)*	*4,077*	*(20)*	*1,795*	*(1,375)*	*(1,430)*	*17,580*
Public Sector	*8,093*	*(58)*	*445*	*(4)*	*197*	*(56)*	*(118)*	*8,617*
Agriculture and forestry	*5,832*	*(8)*	*895*	*(8)*	*1,217*	*(271)*	*(287)*	*7,657*
Balance at the end of the year	835,181	(994)	89,861	(921)	20,662	(7,275)	(9,190)	936,513

Amounts are in ISK millions

42. Credit risk, continued

The table below reconciles the opening and closing allowance balance for loans to customers and debt securities at amortized cost and FVOCI and loan commitments, guarantees and unused credit facilities by impairment stages. 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, impairment of interest income due to impaired debt instruments and unwinding of the time value discount due to the passage of time.

New financial assets, originated or purchased

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 year.

Foreign exchange rates

The effects of foreign exchange rate changes on the loss allowance between periods.

2020

Impairment loss allowance *	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,137	1,166	7,141	209	9,653
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	3,394	(3,116)	(278)	-	-
Transfers to Stage 2 (lifetime ECL)	(1,052)	1,085	(33)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(82)	(816)	898	-	-
Net remeasurement of loss allowance **	(2,282)	5,598	2,773	20	6,109
New financial assets, originated or purchased	1,713	428	1,067	-	3,208
Derecognitions and maturities	(756)	(496)	(1,882)	-	(3,134)
Write-offs ***	-	(2)	(2,977)	(149)	(3,128)
Foreign exchange rate difference	11	35	286	4	336
Impairment loss allowance ******	2,083	3,882	6,995	84	13,044
Impairment loss allowances for assets only carrying 12-month ECL	113	-	-	-	113
Total impairment loss allowance	2,196	3,882	6,995	84	13,157

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in these Consolidated Financial Statements.

** During the year the loss allowance balance for stage 3 loans was raised by ISK 640 million due to unwinding of interest income.

*** During the year an amount of ISK 3,312 million was written off but is still subject to enforcement activities subject to Icelandic law.

**** Loss allowance for all assets other than cash, bonds and loans to credit institutions.

Amounts are in ISK millions

42. Credit risk, continued

Impairment loss allowance for loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	974	921	7,067	209	9,171
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	3,109	(2,838)	(271)	-	-
Transfers to Stage 2 (lifetime ECL)	(994)	1,027	(33)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(80)	(812)	892	-	-
Net remeasurement of loss allowance	(2,045)	5,141	2,626	20	5,742
New financial assets, originated or purchased	1,295	213	1,063	-	2,571
Derecognitions and maturities	(420)	(382)	(1,821)	-	(2,623)
Write-offs	-	(2)	(2,977)	(149)	(3,128)
Foreign exchange rate differences	5	37	278	4	324
Total loss allowance for loans to customers	1,844	3,305	6,824	84	12,057

Impairment loss allowance for loans to customers - Individuals					
Balance at the beginning of the year	418	319	1,601	209	2,547
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	1,594	(1,451)	(143)	-	-
Transfers to Stage 2 (lifetime ECL)	(520)	548	(28)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(48)	(333)	381	-	-
Net remeasurement of loss allowance	(832)	1,393	721	20	1,302
New financial assets, originated or purchased	345	20	26	-	391
Derecognitions and maturities	(151)	(99)	(428)	-	(678)
Write-offs	-	(2)	(975)	(149)	(1,126)
Foreign exchange rate differences	1	-	34	4	39
Total loss allowance for individuals	807	395	1,189	84	2,475

Impairment loss allowance for loans to customers - Companies and sovereign					
Balance at the beginning of the year	556	602	5,466	-	6,624
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	1,515	(1,387)	(128)	-	-
Transfers to Stage 2 (lifetime ECL)	(474)	479	(5)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(32)	(479)	511	-	-
Net remeasurement of loss allowance	(1,213)	3,748	1,905	-	4,440
New financial assets, originated or purchased	950	193	1,037	-	2,180
Derecognitions and maturities	(269)	(283)	(1,393)	-	(1,945)
Write-offs	-	-	(2,002)	-	(2,002)
Foreign exchange rate differences	4	37	244	-	285
Total loss allowance for companies and sovereign	1,037	2,910	5,635	-	9,582

Impairment loss allowance for loan commitments, guarantees and unused credit facilities					
Balance at the beginning of the year	163	245	74	-	482
Transfers					
Transfers to 12-month ECL	285	(278)	(7)	-	-
Transfers to lifetime ECL	(58)	58	-	-	-
Transfers to credit impaired	(2)	(4)	6	-	-
Net remeasurement of loss allowance	(237)	457	147	-	367
New financial commitments originated	418	215	4	-	637
Derecognitions and maturities	(336)	(114)	(61)	-	(511)
Foreign exchange rate differences	6	(2)	8	-	12
Total loss allowance for loan commit., guarantees, unused cr. facili	239	577	171	-	987

Amounts are in ISK millions

42. Credit risk, continued

2019

*Impairment loss allowance **	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,562	1,416	6,358	1,244	10,625
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	2,193	(1,761)	(432)	-	-
Transfers to Stage 2 (lifetime ECL)	(675)	779	(104)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(136)	(1,139)	1,275	-	-
Net remeasurement of loss allowance **	(2,291)	1,945	3,181	650	3,485
New financial assets, originated or purchased	1,037	325	1,488	-	2,850
Derecognitions and maturities	(544)	(392)	(1,696)	(1,675)	(4,307)
Write-offs ***	(20)	-	(2,987)	(102)	(3,109)
Foreign exchange rate differences	13	(8)	57	92	154
Impairment loss allowance ******	1,139	1,165	7,140	209	9,698
Impairment loss allowances for assets only carrying 12-month ECL	22	-	-	-	22
Total impairment loss allowance	1,161	1,165	7,140	209	9,720

* These amounts are a combination of all impairments, including an allowance for loan commitments and guarantees presented as a liability in these Consolidated Financial Statements.

** During the year the loss allowance balance for stage 3 loans was raised by ISK 789 million due to unwinding of interest income.

*** During the year an amount of ISK 2,672 million was written off but is still subject to enforcement activities subject to Icelandic law.

**** Loss allowance for all assets other than cash, bonds and loans to credit institutions.

Impairment loss allowance for loans to customers	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	1,415	931	6,301	1,244	9,891
Transfers of financial assets:					
Transfers to Stage 1 (12-month ECL)	1,939	(1,507)	(432)	-	-
Transfers to Stage 2 (lifetime ECL)	(624)	728	(104)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(133)	(675)	808	-	-
Net remeasurement of loss allowance	(1,981)	1,542	2,754	650	2,965
New financial assets, originated or purchased	637	85	1,462	-	2,184
Derecognitions and maturities	(270)	(168)	(788)	(1,675)	(2,901)
Write-offs	(17)	(7)	(2,991)	(102)	(3,117)
Foreign exchange rate differences	8	(8)	57	92	149
Total loss allowance for loans to customers	974	921	7,067	209	9,171

Impairment loss allowance for loans to customers - Individuals	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	740	313	2,406	232	3,691
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	1,195	(948)	(247)	-	-
Transfers to Stage 2 (lifetime ECL)	(341)	423	(82)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(96)	(393)	489	-	-
Net remeasurement of loss allowance	(1,197)	993	415	75	286
New financial assets, originated or purchased	246	3	13	-	262
Derecognitions and maturities	(112)	(66)	(210)	-	(388)
Write-offs	(17)	(7)	(1,198)	(99)	(1,321)
Foreign exchange rate differences	-	1	15	1	17
Total loss allowance for individuals	418	319	1,601	209	2,547

Amounts are in ISK millions

42. Credit risk, continued

Impairment loss allowance for loans to customers - Companies and	Stage 1	Stage 2	Stage 3	POCI	Total
Balance at the beginning of the year	675	618	3,895	1,012	6,200
Transfers of financial assets					
Transfers to Stage 1 (12-month ECL)	744	(559)	(185)	-	-
Transfers to Stage 2 (lifetime ECL)	(283)	305	(22)	-	-
Transfers to Stage 3 (credit impaired financial assets)	(37)	(282)	319	-	-
Net remeasurement of loss allowance	(784)	549	2,339	575	2,679
New financial assets, originated or purchased	391	82	1,449	-	1,922
Derecognitions and maturities	(158)	(102)	(578)	(1,675)	(2,513)
Write-offs	-	-	(1,793)	(3)	(1,796)
Foreign exchange rate differences	8	(9)	42	91	132
Total loss allowance for companies and sovereign	556	602	5,466	-	6,624

Impairment loss allowance for loan commitments, guarantees and unused credit facilities					
Balance at the beginning of the year	147	485	57	-	689
Transfers					
Transfers to 12-month ECL	254	(254)	-	-	-
Transfers to lifetime ECL	(51)	51	-	-	-
Transfers to credit impaired	(3)	(464)	467	-	-
Net remeasurement of loss allowance	(312)	404	428	-	520
New financial commitments originated	400	240	26	-	666
Derecognitions and maturities	(274)	(224)	(908)	-	(1,406)
Foreign exchange rate differences	(3)	7	4	-	8
Other	5	-	-	-	5
Total loss allowance for loan commit., guarantees, unused cr. facili	163	245	74	-	482

Macroeconomic forecast

The calculation of expected credit losses under IFRS 9 uses forward-looking information in the form of scenarios where the development of macro-economic variables are predicted. The expected credit loss is a probability-weighted average of the estimated forecasts over three scenarios: base case (65%), pessimistic (20%) and optimistic (15%). The macroeconomic forecast and scenario probability weights is done by the Bank's Chief Economist and approved by the Bank's IFRS 9 committee. The following table shows values used for IFRS 9 impairment calculations at year end 2020.

	Base case		
	2021	2022	2023
Unemployment rate	8.0%	6.3%	5.6%
Housing prices	6.0%	5.2%	4.9%
Private consumption	2.7%	3.8%	3.0%
GDP	2.8%	5.3%	4.6%

	Optimistic			Pessimistic		
	2021	2022	2023	2021	2022	2023
Unemployment rate	6.0%	5.4%	4.9%	10.3%	8.6%	6.8%
Housing prices	8.9%	6.7%	5.5%	2.3%	3.1%	5.7%
Private consumption	6.6%	3.5%	2.1%	-1.2%	5.4%	3.4%
GDP	4.6%	7.2%	5.0%	-0.4%	4.4%	3.4%

Sensitivity analysis

Regarding macroeconomic outlook, see Note 3, Significant accounting estimates and judgements. The Group calculates loss for three different scenarios, optimistic, neutral and pessimistic and the loss allowance is the weighted average of the results. As a sensitivity analysis, it can be noted that the loss allowance in stage 1 and 2 for each of these scenarios separately is ISK 2.3 billion, ISK 4.9 billion and ISK 13.7 billion for the optimistic, base case and pessimistic scenarios, respectively.

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

42. Credit risk, continued

Payment moratoria and groups with special focus due to the Covid-19 pandemic

Three groups of customers have been identified as a focus for the assessment of the impact of the Covid-19 pandemic on the Group; i) Tourism; where there is a high probability of impact due to public health restrictions; ii) Customers which have had active payment moratoria in the fourth quarter of 2020; and iii) Recipients of loans through government sponsored loan schemes initiated as a consequence of the crisis. The exposure to these groups is shown in the following table, broken down by industry sector. Also shown is the amount secured by real estate as this is the largest type of collateral for loans to customers. The same customer can be in more than one group.

2020	Tourism dependent	Payment moratoria in Q4 2020	Recipient governmen sponsored loans	All focus groups	Thereof secured by real estate
Individuals	3,912	12,598	130	16,496	15,704
Real estate and construction	25,549	13,858	1,667	33,327	32,980
Services	5,593	1,311	2,384	6,366	2,897
Transportation	9,166	1,013	905	9,173	262
Industry, energy and manufacturing	27	2,622	496	3,014	1,917
Wholesale and retail trades	32,717	20,842	17,831	33,568	30,349
Other sectors	934	4,151	1,032	5,615	2,278
Gross carrying amount	77,898	56,395	24,445	107,559	86,387
Loss allowance	(5,148)	(1,583)	(1,354)	(5,524)	
Book value	72,750	54,812	23,091	102,035	

The following table shows loans to customers which have been granted moratoria during the year including those where the moratoria are no longer active. Also shown are loans to customers that have active moratoria at the end of the year.

	Individuals	Companies
Moratoria granted, including loans where the moratoria are no longer active	54,556	87,445
Active moratoria at year-end	8,702	26,171

The exposures to the focus groups were divided into four groups by impact assessment. The largest exposures in tourism were individually assessed into the four impact groups based on summer 2020 performance and outlook. In group 1 the assessed impact is minimal. In groups 2, 3 and 4 the impact is assessed to correspond to a worse rating by 1, 2 and 3 notches, respectively. The average assessed impact was group 3 (two notches) and other customers in the focus group were therefore given that assessment.

	Impact group 1	Impact group 2	Impact group 3	Impact group 4	Total
Individuals	-	-	16,496	-	16,496
Real estate and construction	-	1,912	28,833	2,582	33,327
Services	157	-	5,831	378	6,366
Transportation	6,432	318	1,602	821	9,173
Industry, energy and manufacturing	-	-	3,014	-	3,014
Wholesale and retail trades	5	209	26,401	6,953	33,568
Other sectors	-	-	5,615	-	5,615
Gross carrying amount	6,594	2,439	87,792	10,734	107,559
Loss allowance	(18)	(26)	(4,991)	(489)	(5,524)
Book value	6,576	2,413	82,801	10,245	102,035

The following table shows the effect of the impact assessment on the distribution of exposure into risk classes

	Before impact assessment	After impact assessment
Risk class 0 to 1 (Grades AAA to BBB-)	22,873	11,365
Risk class 2 (Grades BB+ to BB-)	31,196	18,407
Risk class 3 (Grades B+ to B-)	27,435	44,660
Risk class 4 (Grades CCC+ to CCC-)	14,565	21,901
Risk class 5 (DD)	10,904	10,640
Unrated	586	586
Gross carrying amount	107,559	107,559

Amounts are in ISK millions

43. 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 Group'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 manages and limits market risk exposure in accordance with its risk appetite and strategic goals for net profit.

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 generally applies cash flow hedging for its foreign denominated fixed rate borrowings. For domestic rates, longer fixing periods are more common.

Due to favorable refinancing spreads, prepayments and refinancing of loans have been considerable over the past few years, resulting in a reduced average duration of fixed rates for the Bank's assets. Prepayment risk is mitigated by prepayment fees and the Group's own prepayment options. Decreasing domestic interest rates furthermore put pressure on the Group's net interest income as a result of tighter margins for deposit funding.

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 24, and are therefore different from the amounts shown in these Consolidated 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. The assets and liabilities of Valitor hf. are not included in the figures as they are classified as held for sale.

2020	Up to 3	3-12	1-5	5-10	Over 10	
Assets	months	months	years	years	years	Total
Balances with Central Bank	38,794	-	-	-	-	38,794
Loans to credit institutions	28,235	-	-	-	-	28,235
Loans to customers	568,875	63,622	172,247	4,838	17,670	827,252
Financial instruments	33,329	61,122	38,392	1,672	4,171	138,686
Assets	669,233	124,744	210,639	6,510	21,841	1,032,967
Liabilities						
Due to credit institutions and Central Bank	13,031	-	-	-	-	13,031
Deposits	540,730	15,367	9,610	1,542	1,175	568,424
Borrowings	15,410	42,351	191,650	55,533	11,699	316,643
Subordinated liabilities	15,831	-	17,957	975	-	34,763
Liabilities	585,002	57,718	219,217	58,050	12,874	932,861
Derivatives and other off-balance sheet items (net position)	(119,170)	31,260	91,774	861	-	4,725
Net interest gap	(34,939)	98,286	83,196	(50,679)	8,967	104,831

Amounts are in ISK millions

43. Market risk, continued

2019 *Assets*	Up to 3 months	3-12 months	1-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	91,511	-	-	-	-	91,511
Loans to credit institutions	17,947	-	-	-	-	17,947
Loans to customers	497,936	84,260	148,015	9,076	38,033	777,320
Financial instruments	24,470	9,625	9,743	1,150	3,925	48,913
Assets	631,864	93,885	157,758	10,226	41,958	935,691
Liabilities						
Due to credit institutions and Central Bank	5,984	-	-	-	-	5,984
Deposits	449,627	30,875	9,826	1,474	1,114	492,916
Borrowings	35,359	5,668	174,814	89,264	11,484	316,589
Subordinated liabilities	13,975	-	-	6,202	-	20,177
Liabilities	504,945	36,543	184,640	96,940	12,598	835,666
Derivatives and other off-balance sheet items (net position)	(102,295)	25	104,180	869	-	2,779
Net interest gap	24,624	57,367	77,298	(85,845)	29,360	102,804

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 primarily based on contractual interest rate adjustments where it is simplistically assumed that all rates are equally sensitive to the presumed change in market rates. Behavioral maturity assumptions are however applied for non-maturing deposits and a zero percentage floor is applied to krona deposit interest rates.

	2020		2019	
NPV change	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	(3,849)	3,511	(3,198)	2,651
ISK, Non index-linked	933	(1,002)	(135)	210
Foreign currencies	301	(327)	365	(392)
NII change				
ISK, CPI index-linked	(1,032)	309	(751)	719
ISK, Non index-linked	(3,414)	668	(1,078)	434
Foreign currencies	(27)	27	200	(200)

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.

	2020		2019	
Currency	-100 bps	+100 bps	-100 bps	+100 bps
ISK, CPI index-linked	117	(105)	83	(74)
ISK, Non index-linked	185	(169)	107	(100)
Foreign currencies	34	(34)	(77)	73

Amounts are in ISK millions

43. Market risk, continued

Indexation risk

A significant part of the Group's balance sheet is linked to the Icelandic Consumer Price Index (CPI). For index-linked instruments, principal and interest payments are adjusted proportionally to 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

2020	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	12,366	49,754	195,666	257,786
Financial instruments	14,917	-	-	14,917
Off-balance sheet position	-	(487)	-	(487)
Assets, CPI index-linked	27,283	49,267	195,666	272,216
Liabilities, CPI index-linked				
Deposits	77,805	13,322	2,724	93,851
Borrowings	10,851	42,747	54,865	108,463
Subordinated liabilities	-	-	5,088	5,088
Other	1,091	208	1,318	2,617
Off-balance sheet position	3,334	3,739	45	7,118
Liabilities, CPI index-linked	93,081	60,016	64,040	217,137
Net on-balance sheet position	(62,464)	(6,523)	131,671	62,684
Net off-balance sheet position	(3,334)	(4,226)	(45)	(7,605)
CPI Balance	(65,798)	(10,749)	131,626	55,079
CPI Balance for prudential consolidation, excluding insurance operations *	(65,668)	(13,386)	126,684	47,632

2019	Up to 1 year	1 to 5 years	Over 5 years	Total
Assets, CPI index-linked				
Loans to customers	18,945	57,405	207,514	283,864
Financial instruments	13,647	-	-	13,647
Assets, CPI index-linked	32,592	57,405	207,514	297,511
Liabilities, CPI index-linked				
Deposits	75,944	13,381	2,582	91,907
Borrowings	269	11,329	89,644	101,242
Subordinated liabilities	-	-	4,913	4,913
Other	1,046	210	1,427	2,683
Off-balance sheet position	1,036	6,675	125	7,836
Liabilities, CPI indexed linked	78,295	31,595	98,691	208,581
Net on-balance sheet position	(44,667)	32,485	108,948	96,766
Net off-balance sheet position	(1,036)	(6,675)	(125)	(7,836)
CPI Balance	(45,703)	25,810	108,823	88,930
CPI Balance for prudential consolidation, excluding insurance operations *	(52,586)	26,020	109,256	82,689

* Consolidated situation as per EU Regulation No 575/2013 (CRR)

Amounts are in ISK millions

43. 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. Net exposures per currency are monitored centrally in the Bank.

Breakdown of assets and liabilities by currency

2020

Financial assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	40,996	407	270	153	77	40	193	42,136
Loans to credit institutions	6,453	9,785	4,631	1,158	756	2,397	3,055	28,235
Loans to customers	665,640	105,764	34,653	6,257	4,189	833	5,605	822,941
Financial instruments	154,745	27,274	38,139	24	4	6,917	148	227,251
Other financial assets	7,458	208	3,460	1	-	22	(1,482)	9,667
Financial assets	875,292	143,438	81,153	7,593	5,026	10,209	7,519	1,130,230
Financial liabilities								
Due to credit inst. and Central Bank	7,433	3,235	2,348	14	-	-	1	13,031
Deposits	494,606	32,505	29,069	1,992	2,895	4,556	2,801	568,424
Financial liabilities at fair value	4,925	95	171	44	-	4	1	5,240
Other financial liabilities	4,444	857	2,103	150	275	53	128	8,010
Borrowings	153,764	124,032	-	-	-	18,813	2,338	298,947
Subordinated liabilities	5,995	794	13,498	-	-	4,508	11,265	36,060
Financial liabilities	671,167	161,518	47,189	2,200	3,170	27,934	16,534	929,712
Net on-balance sheet position	204,125	(18,080)	33,964	5,393	1,856	(17,725)	(9,015)	
Net off-balance sheet position	(9,148)	22,434	(31,586)	(5,184)	(1,932)	17,739	7,677	
Net position	194,977	4,354	2,378	209	(76)	14	(1,338)	
Non-financial assets								
Investment property	6,132	-	-	-	-	-	-	6,132
Investments in associates	891	-	-	-	-	-	-	891
Intangible assets	9,689	-	-	-	-	-	-	9,689
Tax assets	2	-	-	-	-	-	-	2
Assets and disposal groups held for sale	13,709	955	132	920	947	10	138	16,811
Other non financial assets	7,228	121	20	71	-	26	1,485	8,951
Non-financial assets	37,651	1,076	152	991	947	36	1,623	42,476
Non-financial liabilities and equity								
Tax liabilities	4,262	-	-	-	-	-	-	4,262
Liabilities associated with disposal groups held for sale	13,184	268	66	467	1,765	224	209	16,183
Other non-financial liabilities	24,508	119	73	-	4	-	-	24,704
Shareholders' equity	197,672	-	-	-	-	-	-	197,672
Non-controlling interest	173	-	-	-	-	-	-	173
Non-financial liabilities and equity	239,799	387	139	467	1,769	224	209	242,994
Management reporting of currency risk *	(7,171)	5,043	2,391	733	(898)	(174)	76	

* The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying 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

43. Market risk, continued

2019

Financial assets	ISK	EUR	USD	GBP	DKK	NOK	Other	Total
Cash and balances with CB	94,363	534	286	173	65	53	243	95,717
Loans to credit institutions	2,024	5,845	4,835	1,355	628	656	2,604	17,947
Loans to customers	608,144	116,793	35,113	3,956	4,578	2	5,369	773,955
Financial instruments	73,482	18,253	22,618	35	2	2,868	148	117,406
Other financial assets	5,354	160	3,096	-	22	4	39	8,675
Financial assets	783,367	141,585	65,948	5,519	5,295	3,583	8,403	1,013,700
Financial liabilities								
Due to credit inst. and Central Bank	2,548	1,748	1,675	13	-	-	-	5,984
Deposits	424,136	28,730	30,729	2,071	2,504	2,900	1,846	492,916
Financial liabilities at fair value	1,665	561	66	17	-	192	69	2,570
Other financial liabilities	4,178	335	967	201	371	53	303	6,408
Borrowings	147,245	116,712	-	-	-	32,999	7,789	304,745
Subordinated liabilities	5,820	690	-	-	-	4,183	9,390	20,083
Financial liabilities	585,592	148,776	33,437	2,302	2,875	40,327	19,397	832,706
Net on-balance sheet position	197,775	(7,191)	32,511	3,217	2,420	(36,744)	(10,994)	
Net off-balance sheet position	(2,575)	1,522	(36,242)	(4,825)	(4,694)	36,252	10,562	
Net position	195,200	(5,669)	(3,731)	(1,608)	(2,274)	(492)	(432)	
Non-financial assets								
Investment property	7,119	-	-	-	-	-	-	7,119
Investments in associates	852	-	-	-	-	-	-	852
Intangible assets	8,367	-	-	-	-	-	-	8,367
Tax assets	2	-	-	-	-	-	-	2
Assets and disposal groups								-
held for sale	20,632	13,080	1,302	5,637	1,206	307	1,462	43,626
Other non financial assets	7,963	119	27	56	1	18	5	8,189
Non-financial assets	44,935	13,199	1,329	5,693	1,207	325	1,467	68,155
Non-financial liabilities and equity								
Tax liabilities	4,404	-	-	-	-	-	-	4,404
Liabilities associated with disposal								
groups held for sale	11,442	8,667	71	2,849	2,597	496	2,509	28,631
Other non-financial liabilities	26,097	141	46	-	5	-	-	26,289
Shareholders' equity	189,644	-	-	-	-	-	-	189,644
Non-controlling interest	181	-	-	-	-	-	-	181
Non-financial liabilities and equity	231,768	8,808	117	2,849	2,602	496	2,509	249,149
Intangible assets of Valitor in foreign								
operation excluded *	1,534	-	-	(1,455)	(79)	-	-	
Management reporting								
of currency risk **	9,901	(1,278)	(2,519)	(219)	(3,748)	(663)	(1,474)	

* Based on an authorization from the Icelandic FSA to exclude Valitor's intangible assets in the currency balance.

** The net position of the currency risk is presented in accordance with IFRS. The management monitors currency risk with more assets and liabilities underlying 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

43. Market risk, continued

Sensitivity analysis for 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 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).

	2020		2019	
Currency	-10%	+10%	-10%	+10%
EUR	(504)	504	128	(128)
USD	(239)	239	252	(252)
GBP	(73)	73	22	(22)
DKK	90	(90)	375	(375)
NOK	17	(17)	66	(66)
Other	(8)	8	147	(147)

Equity risk

Equity risk is the risk that the fair value of equities decreases. For information on assets seized and held for sale and equity exposures, see Notes 30 and 23 respectively.

Sensitivity analysis for equity risk

The analysis below calculates the effect of a reasonable possible movement in equity prices that affect the Consolidated Financial Statements. A negative amount in the table reflects a potential net reduction in the Consolidated 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 Risk Disclosures.

	2020		2019	
Equity	-10%	+10%	-10%	+10%
Trading book - listed	(391)	391	(301)	301
Banking book - listed	(382)	382	(486)	486
Banking book - unlisted	(276)	276	(296)	296

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 hedge market risk on its balance sheet. Note 24 provides a breakdown of the Group's derivative positions by type.

Amounts are in ISK millions

44. 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.

A primary source of funding for the Group is from 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 73% 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 or pledged to the Central Bank of Iceland and thus converted into cash at very short notice.

Contractual cash flow of assets and liabilities

2020 *Financial assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Cash and balances with CB	5,723	30,210	6,299	-	-	-	42,232	42,136
Loans to credit institutions	20,170	8,065	-	-	-	-	28,235	28,235
Loans to customers	4,643	109,363	106,656	307,086	600,174	-	1,127,922	822,941
Financial instruments	32,665	35,485	67,721	52,118	13,778	35,007	236,774	227,251
Derivatives - assets leg	-	*63,147*	*35,669*	*8,328*	*1,116*	-	*108,260*	*105,362*
Derivatives - liabilities leg	-	*(61,599)*	*(32,638)*	*(4,628)*	*(776)*	-	*(99,641)*	*(98,078)*
Other financial instruments	*32,665*	*33,937*	*64,690*	*48,418*	*13,438*	*35,007*	*228,155*	*219,967*
Other financial assets	534	5,413	2,882	838	-	-	9,667	9,667
Financial assets	63,735	188,536	183,558	360,042	613,952	35,007	1,444,830	1,130,230
Financial liabilities								
Due to credit inst. and Central Bank	11,491	1,550	28	-	-	-	13,069	13,031
Deposits	414,052	106,071	32,169	13,717	3,007	-	569,016	568,424
Financial liabilities at fair value	-	4,123	1,116	1,349	44	-	6,632	5,240
Derivatives - assets leg	-	*(46,444)*	*(5,067)*	*(9,196)*	*(413)*	-	*(61,120)*	*(55,928)*
Derivatives - liabilities leg	-	*49,798*	*6,183*	*10,545*	*457*	-	*66,983*	*60,399*
Short position in bonds	-	*40*	-	-	-	-	*40*	*40*
Short position in equity	-	*63*	-	-	-	-	*63*	*63*
Short position in bonds used for hedging	-	*666*	-	-	-	-	*666*	*666*
Other financial liabilities	82	5,423	112	1,328	1,066	-	8,011	8,011
Borrowings	-	2,803	50,635	212,471	65,633	-	331,542	298,947
Subordinated liabilities	-	1,178	943	19,762	25,586	-	47,469	36,060
Financial liabilities	425,625	121,148	85,003	248,627	95,336	-	975,739	929,713
Net position for assets and liab.	(361,890)	67,388	98,555	111,415	518,616	35,007	469,091	200,517
Off-balance sheet items								
Financial guarantees	-	593	4,539	2,016	13,709	-	20,857	20,857
Unused overdraft	-	49,164	-	-	-	-	49,164	49,164
Undrawn loan commitments	-	51,231	8,910	3,914	-	-	64,055	64,055
Off-balance sheet items	-	100,988	13,449	5,930	13,709	-	134,076	134,076
Net contractual cash flow	(361,890)	(33,600)	85,106	105,485	504,907	35,007	335,015	66,441

Amounts are in ISK millions

44. Liquidity and Funding risk, continued

2019 *Financial assets*	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	With no maturity	Total	Book value
Cash and balances with CB	6,352	84,434	5,059	-	-	-	95,845	95,717
Loans to credit institutions	15,652	2,295	-	-	-	-	17,947	17,947
Loans to customers	6,191	124,040	105,974	299,695	578,647	-	1,114,547	773,955
Financial instruments	16,381	28,346	11,451	22,612	10,238	34,063	123,091	117,406
Derivatives - assets leg	-	*69,432*	*12,020*	*48,571*	*357*	-	*130,380*	*124,911*
Derivatives - liabilities leg	-	*(66,935)*	*(11,006)*	*(43,875)*	*(294)*	-	*(122,110)*	*(118,295)*
Other financial instruments	*16,381*	*25,849*	*10,437*	*17,916*	*10,175*	*34,063*	*114,821*	*110,790*
Other financial assets	577	4,618	2,656	824	-	-	8,675	8,675
Financial assets	45,153	243,733	125,140	323,131	588,885	34,063	1,360,105	1,013,700
Financial liabilities								
Due to credit inst. and Central Bank	5,997	-	26	-	-	-	6,023	5,984
Deposits	350,451	78,459	42,423	14,318	9,279	-	494,930	492,916
Financial liabilities at fair value	-	1,506	1,318	1,812	44	-	4,680	2,570
Derivatives - assets leg	-	*(48,335)*	*(6,983)*	*(8,218)*	*(1,360)*	-	*(64,896)*	*(63,456)*
Derivatives - liabilities leg	-	*49,326*	*8,301*	*10,030*	*1,404*	-	*69,061*	*65,510*
Short position bonds and derivatives	-	*408*	-	-	-	-	*408*	*409*
Short position securities used for economic hedging	-	*107*	-	-	-	-	*107*	*107*
Other financial liabilities	141	3,856	119	559	1,733	-	6,408	6,408
Borrowings	-	7,416	32,028	202,725	101,862	-	344,031	304,745
Subordinated liabilities	-	479	566	3,316	23,908	-	28,269	20,083
Financial liabilities	356,589	91,716	76,480	222,730	136,826	-	884,341	832,706
Net position for assets and liab.	(311,436)	152,017	48,660	100,401	452,059	34,063	475,764	180,994
Off-balance sheet items								
Financial guarantees	554	2,617	1,202	3,560	7,164	-	15,097	15,097
Unused overdraft	-	44,923	-	-	-	-	44,923	44,923
Undrawn loan commitments	-	43,406	9,455	1,240	-	-	54,101	54,101
Off-balance sheet items	554	90,946	10,657	4,800	7,164	-	114,121	114,121
Net contractual cash flow	(311,990)	61,071	38,003	95,601	444,895	34,063	361,643	66,873

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 stickiness. The NSFR for foreign currency shall exceed 100%.

The NSFR calculations are based solely on figures for the parent company. The Bank's subsidiaries have a negligible impact on the funding ratio. 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 the one in there Consolidated Financial Statements due to the sub-consolidation applied.

2020	ISK	Foreign currency	Total
Available stable funding	705,538	169,723	875,261
Required stable funding	618,456	126,594	745,050
Foreign currency balance		(150)	
Net stable funding ratio	114%	134%	117%
2019			
Available stable funding	640,719	182,728	823,447
Required stable funding	566,797	141,533	708,330
Foreign currency balance		(4,122)	
Net stable funding ratio	113%	126%	116%

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

44. Liquidity and Funding risk, continued

Liquidity coverage ratio

The Liquidity Coverage Ratio (LCR) is one 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 precisely, 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, traded on an active market 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. The ratio is based on consolidated figures for the Bank and Valitor hf.

2020	ISK	Foreign currency	Total
Liquid assets level 1 *	103,138	61,282	164,420
Liquid assets level 2	10,515	-	10,515
Liquid assets	113,653	61,282	174,935
Deposits	99,885	27,592	127,477
Borrowings	287	64	351
Other cash outflows	10,427	11,678	22,105
Cash outflows	110,599	39,334	149,933
Short-term deposits with other banks **	3,178	19,501	22,679
Other cash inflows	28,251	6,194	34,445
Cash inflows	31,429	25,695	57,124
Liquidity coverage ratio (LCR) * **	144%	449%	188%

2019			
Liquid assets level 1 *	107,918	28,973	136,891
Liquid assets level 2	291	-	291
Liquid assets	108,209	28,973	137,182
Deposits	89,609	23,655	113,264
Borrowings	2,081	10	2,091
Other cash outflows	7,479	11,082	18,561
Cash outflows	99,169	34,747	133,916
Short-term deposits with other banks **	-	18,185	18,185
Other cash inflows	30,743	9,201	39,944
Cash inflows	30,743	27,386	58,129
Liquidity coverage ratio (LCR) * **	158%	334%	188%

* 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 foreign covered bonds are also classified as Level 1 assets and

** 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

44. Liquidity and Funding risk, continued

Composition of liquid assets

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

2020	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	40,996	270	407	463	42,136
Short-term deposits in other banks	3,179	4,467	7,765	7,268	22,679
Domestic bonds eligible as collateral at the Central Bank	74,637	-	-	-	74,637
Foreign government bonds	-	33,817	20,364	5,956	60,137
Liquidity reserve	118,812	38,554	28,536	13,687	199,589

2019	ISK	USD	EUR	Other	Total
Cash and balances with Central Bank	103,726	286	534	534	105,080
Short-term deposits in other banks	-	5,410	5,771	7,004	18,185
Domestic bonds eligible as collateral at the Central Bank	11,878	-	-	-	11,878
Foreign government bonds	-	13,930	12,234	1,373	27,537
Liquidity reserve	115,604	19,626	18,539	8,911	162,680

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 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 weighted average of the stressed outflow weights.

LCR categorization - amounts and LCR outflow weights	Deposits maturing within 30 days					
2020	Less stable	Weight %	Stable	Weight %	Term deposits*	Total deposits
Individuals	89,950	11%	123,897	5%	73,321	287,168
Small and medium enterprises	52,527	11%	16,180	5%	5,572	74,279
Corporations	64,445	40%	3,854	20%	8,646	76,945
Sovereigns, central banks and PSE	43,379	40%	-	-	12,932	56,311
Pension funds	38,042	100%	-	-	14,325	52,367
Domestic financial entities	22,391	100%	-	-	9,907	32,298
Foreign financial entities	2,087	100%	-	-	-	2,087
Total	312,821		143,931		124,703	581,455

2019	Less stable	Weight %	Stable	Weight %	Term deposits*	Total deposits
Individuals	130,942	10%	52,735	5%	74,580	258,257
Small and medium enterprises	50,339	10%	4,998	5%	6,156	61,493
Corporations	56,694	40%	829	20%	7,170	64,693
Sovereigns, central banks and PSE	13,501	40%	-	-	716	14,217
Pension funds	34,024	100%	-	-	16,431	50,455
Domestic financial entities	20,857	100%	-	-	27,051	47,908
Foreign financial entities	1,877	100%	-	-	-	1,877
Total	308,234		58,562		132,104	498,900

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

Amounts are in ISK millions

Notes to the Consolidated Financial Statements

45. 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 the Icelandic Financial Undertakings Act No. 161/2002 and Regulation No. 233/2017 on prudential requirements. Iceland has adopted the EU Capital Requirements Directive and Regulation (CRD IV / CRR). On 1 January 2020, CRR was incorporated into the EEA Agreement, effectively introducing the SME supporting factor for capital adequacy for Icelandic institutions, which was previously excluded. The Group applies 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, in particular Vördur. The Bank’s holding in the CET1 and T2 equity instruments of Vördur are treated in accordance with CRR articles 36 and 66. From 2020, the Bank has opted to apply the threshold exemption provided for in article 48 and thus the CET1 instrument, valued net of goodwill, is not deducted from CET1 but rather included in REA under credit risk, securities and other with a 250% risk weight. The deduction of the goodwill is now included under Intangible assets. Tax assets are also treated in accordance with article 48 of CRR.

Valitor hf. is classified as held for sale in these Consolidated Financial Statements. This does not affect the Group's capital adequacy calculations. For disclosure, assuming a cash sale of the subsidiary at book value, the Group's capital adequacy ratio would increase from 27.0% to 27.9%. The sale of Valitor would result in a reduction of the Group's regulatory own funds adjustments, with positive effect on capital adequacy.

Own funds	2020	2019
Total equity	197,845	189,825
Deductions related to the consolidated situation	-	(10,159)
Non-controlling interest not eligible for inclusion in CET1 capital	(173)	(181)
Common Equity Tier 1 capital before regulatory adjustments	197,672	179,485
Intangible assets	(13,092)	(10,604)
Tax assets	-	(296)
Cash flow hedges	(2,282)	(1,616)
Additional value adjustments	(238)	(125)
Foreseeable dividend and buyback *	(17,990)	(14,153)
Adjustment under IFRS 9 transitional arrangements	1,890	-
Common equity Tier 1 capital	165,960	152,691
Non-controlling interest not eligible for inclusion in CET1 capital	173	181
Additional Tier 1 capital	13,498	-
Tier 1 capital	179,631	152,872
Tier 2 instruments	22,562	20,083
Tier 2 instruments of financial sector entities (signif. invest.)	(1,007)	-
Tier 2 capital	21,555	20,083
Total own funds	201,186	172,955
Risk-weighted exposure amount (REA)		
Credit risk, loans	570,554	561,602
Credit risk, securities and other	60,813	49,163
Counterparty credit risk	3,462	3,347
Market risk due to currency imbalance	8,569	10,070
Market risk, other	13,063	10,609
Credit valuation adjustment	842	1,477
Operational risk	88,462	83,487
Total risk-weighted exposure amount	745,765	719,755
Capital ratios		
CET1 ratio	22.3%	21.2%
Tier 1 ratio	24.1%	21.2%
Capital adequacy ratio	27.0%	24.0%

* On 31 December 2019, the foreseeable dividend and buyback was the aggregation of the Bank's planned equity reduction in Q1 2020 through dividend distribution and buy back of own shares. Due to the Covid-19 crisis, the plan was halted and no dividend was to be paid for the fiscal year 2019 according to an approval at the extended AGM on 14 May 2020. On 31 December 2020, the foreseeable dividend and buyback is the aggregation of a dividend distribution of ISK 3 billion, which adheres to the guidance of the FSA, and planned buyback of own shares amounting to ISK 15 billion which has received permission from the FSA.

Amounts are in ISK millions

45. Capital management, continued

On 4 May 2020 the Icelandic Ministry of Finance ratified Regulation (EU) 2017/2395 into Icelandic law. The regulation introduces transitional arrangements for IFRS 9 to allow the regulatory capital impact of expected credit loss to be phased in over time. These arrangements have been available to European banks since 2017. Institutions that elect to make use of these transitional arrangements can in 2020 add back CET1 equivalent to up to 70% of provisions incurred from the application of IFRS9 and 50% in 2021. The Bank has opted to make use of the transitional arrangements, thus reflected in the Group's capital ratios for 2020. The transitional arrangements increase the capital adequacy ratio by 0.2 percentage points.

Capital ratios of the parent company	2020	2019
CET1 ratio	22.8%	23.5%
Tier 1 ratio	24.6%	23.5%
Capital adequacy ratio	27.5%	26.2%

The following table outlines the implementation of the capital buffer requirements in accordance with the Icelandic Financial Undertakings Act No. 161/2002, as prescribed by the Financial Stability Council (FSC) and approved by the FSA.

Capital buffer requirement, % of REA	18.3.2020	1.2.2020	31.12.2019
Capital conservation buffer	2.50%	2.50%	2.50%
Capital buffer for systematically important institutions	2.00%	2.00%	2.00%
Systemic risk buffer *	3.00%	3.00%	3.00%
Countercyclical capital buffer *	-	2.00%	2.00%
Combined capital buffer requirement	7.50%	9.50%	9.50%

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 FSA 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 FSA'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 REA

2020	CET1	Tier 1	Total
Pillar 1 capital requirement	4.5%	6.0%	8.0%
Pillar 2R capital requirement **	1.7%	2.3%	3.1%
Combined buffer requirement *	7.3%	7.3%	7.3%
Regulatory capital requirement	13.5%	15.6%	18.4%
Available capital	22.3%	24.1%	27.0%

* The Icelandic buffer value shown. In the combined buffer requirement, the effective countercyclical capital buffer is determined by calculating the weighted average of the corresponding buffer levels of each country, the weights being the total risk-weighted exposures for credit risk against counterparties residing in those countries. The systemic risk buffer only applies to domestic exposures and is calculated using the same weighting method.

** The SREP result based on the Group's Financial Statement at 31 December 2018. Due to the Covid-19 pandemic, the FSA decided that this result would be unchanged in 2020. The Pillar 2 requirement is 3.1% of risk-weighted exposure amount based on the Group's prudential consolidation under CRR, which excludes Vördur 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 the Icelandic Financial Undertakings Act No. 161/2002.

	2020	2019
On-balance sheet exposures	1,114,450	1,022,521
Derivative exposures	9,124	10,217
Securities financing transaction exposures	512	577
Off-balance sheet exposures	65,425	52,299
Total exposure	1,189,511	1,085,614
Tier 1 capital	179,631	152,872
Leverage ratio	15.1%	14.1%

Amounts are in ISK millions

45. Capital management, continued

Solvency II	2020	2019
Excess of assets over liabilities in accordance with Solvency II	7,397	7,110
Subordinated liabilities	1,000	-
Foreseeable dividends	(700)	(500)
Own funds	7,697	6,610
Solvency capital requirements (SCR)	5,105	4,580
SCR ratio	151%	144%

The solvency capital requirement for the subsidiary Vördur is calculated in accordance with the Icelandic Insurance Companies Act.

46. Operational risk

Operational risk is the risk of direct or indirect loss, or damage to the Group's reputation resulting from inadequate or failed internal processes or systems, from human error or external events that affect the Group's image and operational earnings.

Each business unit within the Group is primarily responsible for taking and managing their own operational risk. Risk management is responsible for developing and maintaining tools for identifying, measuring, monitoring and reporting the Group's operational risk.

The Group uses the standardized approach for the calculation of capital requirements for operational risk.

Amounts are in ISK millions

Significant accounting policies

The accounting policies adopted in the preparation of these Consolidated Financial Statements are consistent with those followed in the preparation of the Annual Financial Statements for the year ended 31 December 2019, except for when there have been made amendmends to current IFRS valid from 1 January 2020, Icelandic Act on Financial Statements, Act on Financial Undertakings and rules on Accounting for Credit Institutions. A number of new standards were effective from 1 January 2020 but they do not have a material effect on these Consolidated Financial Statements.

47. Going concern assumption

The Group's management has made an assessment of the ability to continue as a going concern and is satisfied that the Group has the resources to continue. In making this assessment, management has taken into consideration the risk exposures facing the Group, which are further described in the Risk Management Disclosures. The Consolidated Financial Statements are prepared on a going concern basis.

48. Principles underlying the consolidation

Subsidiaries

Subsidiaries are entities controlled by the Group. The Financial Statements of subsidiaries are included in the Consolidated Financial Statements from the date that control commences until the date that control ceases. The Financial Statements of the subsidiaries are prepared for the same reporting period as the parent entity, using consistent accounting policies.

Business combinations

Business combinations are accounted for using the acquisition method as at the acquisition date, i.e. when control is transferred to the Group. The Group controls an investee if, and only if, the Group has:

- power over the investee (i.e. existing rights that give it the current ability to direct the relevant activities of the investee);
- exposure, or rights, to variable returns from its involvement with the investee; and
- the ability to use its power over the investee to affect its returns.

Generally, there is a presumption that a majority of voting rights result in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an investee, the Group considers all relevant facts and circumstances in assessing whether it has power over an investee, including (i) the contractual arrangement with the other vote holders of the investee, (ii) rights arising from other contractual arrangements and (iii) the Group's voting rights and potential voting rights. The Group re-assesses whether or not it controls an investee if facts and circumstances indicate that there are changes to one or more of the three elements of control.

The Group measures goodwill at the acquisition date as:
- the fair value of the consideration transferred; plus
- the recognized amount of any non-controlling interests in the acquiree; less
- if the business combination is achieved in stages, the fair value of the pre-existing equity interest in the acquiree; less
- the net recognized amount (generally fair value) of the identifiable assets acquired and liabilities assumed.

When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss.

Transaction costs incurred are expensed and included in administration expense.

Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Group; such interests are presented separately in the Income Statement and are included in equity in the Statement of Financial Position, separately from equity attributable to owners of the Group.

For each business combination, the Group elects to measure any non-controlling interests in the acquiree either:
- at fair value; or
- at their proportionate share of the acquiree's identifiable net assets, which are generally at fair value.

Changes in the Group's interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions.

48. Principles underlying the consolidation, continued

Loss of control

On the loss of control, the Group derecognizes the assets and liabilities of the subsidiary, any non-controlling interests and the other components of equity related to the subsidiary. Any surplus or deficit arising on the loss of control is recognized in profit or loss.

Transactions eliminated on consolidation

Intragroup balances, income and expenses arising from intragroup transactions, are eliminated in preparing the Consolidated Financial Statements. This also applies to subsidiaries classified as disposal groups held for sale.

Funds management

The Group manages and administers assets held in unit trusts and investment vehicles on behalf of investors. The Financial Statements of these entities are not included in these Consolidated Financial Statements except when the Group controls the entity.

When assessing whether to consolidate investment funds, the Group reviews all facts and circumstances to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal, and hence controls and consolidates a fund, when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings, and is able to influence the returns of the funds by exercising its power. The Group is defined as agent in all instances.

49. Associates

Associates are those entities over which the Group has a significant influence, i.e. the power to participate in the financial and operating policy decisions of the associates but not control or joint control over those policies. Significant influence generally exists when the Group holds 20% or more of the voting power, including potential voting rights, unless it can be clearly demonstrated that this is not the case. Investments in associates are initially recognized at cost. The carrying amount of investments in associates includes intangible assets and accumulated impairment loss.

The considerations made in determining significant influence are similar to those necessary to determine control over subsidiaries.

The Group's investments in its associate are accounted for using the equity method.

The Financial Statements include the Group's share of the total recognized income and expenses of associates from the date that significant influence commences until the date that significant influence ceases. When the Group's share of losses exceeds its carrying value of associate, the Group's carrying amount is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognizing its share of those profits only after its share of the profits equals the share of losses not recognized.

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

Impairment on investments in associates

After applying the equity method to account for investments in associates, the Group determines whether it is necessary to recognize any impairment loss with respect to its investments in associates. The Group first determines whether there is any objective evidence that an investment in an associate is impaired. If such evidence exists, the Group then tests the entire carrying amount of the investment for impairment, by comparing its recoverable amount, which is the higher of value in use and fair value less costs to sell, with its carrying amount. The recoverable amount of an investment in an associate is assessed for each associate, unless the associate does not generate cash inflows from continuing use that are largely independent of those from other assets of the Group. The excess of the carrying amount over the recoverable amount is recognized in the Income statement as an impairment loss. Impairment losses are subsequently reversed through the Income Statement if the reasons for the impairment loss no longer apply.

Notes to the Consolidated Financial Statements

50. Foreign currency

Items included in the Consolidated Financial Statements of each of the Group's subsidiaries are measured using the functional currency of the respective entity.

Foreign currency transactions

Transactions in foreign currencies are translated to the respective functional currencies of Group entities at exchange rates at the dates of transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated to the functional currency at the exchange rate at that date. All differences arising on settlement or translation of monetary items are taken to the Income Statement. Non-monetary assets and liabilities denominated in foreign currencies are reported at historic cost.

51. Interest

Interest income and expense are recognized in the Income Statement using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. The effective interest rate is established on initial recognition of the financial asset and financial liability and is not revised subsequently.

The calculation of the effective interest rate includes all transaction costs and fees and points paid or received that are an integral part of the effective interest rate. Transaction costs include incremental costs that are directly attributable to the acquisition or issue of a financial asset or financial liability.

Interest income and expense presented in the Income Statement include Income and expenses of assets and liabilities carried at:

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

52. Fee and commission

The Group provides various services to its clients and earns income therefrom, such as income from Corporate Banking, Retail Banking, Capital Markets, Corporate Finance, Asset Management and Private Banking. Fees earned from services that are provided over a certain period of time are recognized as the services are provided, i.e. point in time. Fees earned from transaction type services are recognized when the service has been completed, i.e. point in time. Fees that are performance linked are recognized when the performance criteria are fulfilled, i.e. point in time.

Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

53. Net financial income

Net financial income comprises Dividend income, Net gain on financial assets and liabilities at fair value and Net foreign exchange gain.

i) Dividend income is recognized when the right to receive dividend is established. Usually this is the ex-dividend date for equity securities.

ii) Net gain on financial assets and liabilities at fair value comprises all realized and unrealized fair value changes, except for interest (which is included in Interest income and Interest expense) and foreign exchange gain and losses (which are included in Net foreign exchange gains as described below).

iii) Net foreign exchange gain comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous Consolidated Financial Statements.

Net foreign exchange gain also include foreign exchange differences arising on translating non-monetary assets and liabilities which are measured at fair value in foreign currencies and whose other gain and loss are also recognized in profit or loss.

54. Net insurance income

Premiums recognized as income comprise the premiums contracted during the fiscal year including premiums transferred from last years but excluding next periods premiums, which are recognized as provision for unearned premiums. Provision for unearned premiums is a part of the technical provision in the Statement of Financial Position.

Claims recognized in the Income Statement are the periods claims including increases or decreases due to claims from previous fiscal years. Outstanding claims included in technical provision in the Statement of Financial Position are the total amount of reported but unpaid claims as well as actuarial provision for claims occurred but unreported.

55. Income tax expense

Tax expense comprises current and deferred tax. Income tax for the year has been calculated and recognized in the Consolidated Financial Statements.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years. Taxable profit may differ from earnings before tax as reported in the Income Statement as it may exclude income or expense that is deductible in other years and it excludes income or expense that are never taxable or deductible.

Current and deferred tax relating to items recognized directly in equity is recognized in equity and not in the statement of profit or loss.

Deferred tax is recognized in respect of temporary differences between the carrying amounts of assets and liabilities and the realization of foreign exchange gain or loss, for financial reporting purposes and the amounts used for taxation purposes.

Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantively enacted at the reporting date.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realized simultaneously.

A deferred tax asset is recognized for unused tax losses, tax credits and deductible temporary differences to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. Deferred tax assets are reviewed at each reporting date and reduced to the extent that it is no longer probable that the related tax benefit will be realized. Such deferred tax assets and liabilities are not recognized if the temporary difference arises from the initial recognition (other than in a business combination) of assets and liabilities in transaction that affects neither the taxable profit nor the accounting profit. In addition, tax liabilities are not recognized if the temporary difference arises from the initial recognition of goodwill.

56. Financial assets and financial liabilities

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 and for an item not at fair value through profit or loss, transaction cost that are directly attributable to its acquisition or issue.

Derecognition

Financial assets are derecognized when the rights to receive cash flows from the financial assets have expired or when the Group has transferred substantially all risks and rewards of ownership.

Financial liabilities are derecognized when the obligation of the Group specified in the contract is discharged or cancelled or expires.

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); or
- 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 on the principal amount outstanding (here after 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.

56. Financial assets and financial liabilities, continued

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;
- 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, the banks funding costs, the credit risk associated with the principal amount outstanding and other costs (e.g 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 contractual cash payments or receipt through the contractual lifetime 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 Income Statement.

Impairment on debt instruments measured at amortized cost is calculated using the expected credit loss (ECL) approach. Loans and debt securities measured at amortized cost are presented net of allowance for credit losses 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/or 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). At realization the accumulated profit or loss recognized in OCI in previous periods is recycled to the Consolidated Income Statement. Foreign exchange gains and losses of the debt instrument are recognized in the Consolidated Income Statement. Interest income from received payments are recognized in interest income in the Consolidated Income Statement upon payment.

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 with 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.

56. Financial assets and financial liabilities, continued

Debt instruments measured at FVTPL

Debt instrument are measured at FVTPL if they are held for short term gain before maturity, held as part of a portfolio managed on a fair value basis or the cash flows 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 Income Statement.

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 which is recorded as provision for credit losses in the Consolidated Income Statement. 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 Income Statement at the end of all reporting periods subsequent to the date of acquisition.

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 Financial income in the Consolidated Income Statement.

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 Income Statement. Dividends received are recorded in Financial income in the Consolidated Income Statement. 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 Income Statement of the security.

Offsetting

Financial assets and liabilities are set off and the net amount reported in the Statement of Financial Position when, and only when, the Group has a legal right to offset the recognized amounts and intends either to settle on a net basis or to realize the asset and settle the liability simultaneously.

Income and expenses are presented on a net basis only when permitted by the accounting standards, or for gains or losses arising from a group of similar transactions such as in the Group's trading activity.

56. Financial assets and financial liabilities, continued

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 are primarily debt instruments (including loans to customers) measured at amortized cost or FVOCI. 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.

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 rates.
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 an unbiased discounted probability-weighted estimate of the cash shortfalls expected to result from defaults occurring in the next 12 months or, in cases where credit risk has significantly increased, in the expected lifetime of an exposure. 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, contingent on significant financial difficulty.

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 asset 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, each exposure portfolio is assessed separately, meaning that if an individual is in default on a loan belonging to one portfolio, their other exposures, belonging to other portfolios, are not automatically assumed to be in default. However, default in other portfolios are considered when assessing unlikeliness to pay. The Bank now defines six different exposure portfolios for individuals and has different statistical credit risk model for each of them - mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans.

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.

56. Financial assets and financial liabilities, continued

The Group's rating scale is shown below, including mapping of external ratings. The lower bounds are inclusive.

Risk class	Rating	Lower PD	Upper PD	S&P / Fitch	Moody's	Description
0	AAA	0.000%	0.006%	AAA	Aaa	Investment Grade
	AA+	0.006%	0.018%	AA+	Aa1	
	AA	0.018%	0.029%	AA	Aa2	
	AA-	0.029%	0.045%	AA-	Aa3	
1	A+	0.045%	0.070%	A+	A1	Investment Grade
	A	0.070%	0.110%	A	A2	
	A-	0.110%	0.170%	A-	A3	
	BBB+	0.170%	0.260%	BBB+	Baa1	
	BBB	0.260%	0.410%	BBB	Baa2	
	BBB-	0.410%	0.640%	BBB-	Baa3	
2	BB+	0.640%	0.990%	BB+	Ba1	Non-investment Grade
	BB	0.990%	1.540%	BB	Ba2	
	BB-	1.540%	2.400%	BB-	Ba3	
3	B+	2.400%	3.730%	B+	B1	Non-investment Grade
	B	3.730%	5.800%	B	B2	
	B-	5.800%	9.010%	B-	B3	
4	CCC+	9.010%	14.000%			Non-investment Grade
	CCC	14.000%	31.000%			
	CCC-	31.000%	99.990%			
5	DD	99.99%	100.00%	D	C	Default / Impaired

The Group uses external ratings for counterparties that receive such ratings from recognized rating agencies such as Moody's, Standard & Poor's and Fitch. The Group's internal rating scale was originally calibrated to match historical default rates shown in publications of the aforementioned rating agencies and using smoothing techniques. 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 available information at the time of origination. Exposures are continuously monitored and revaluated using the models described above and this may result in transitions between risk ratings.

Probability of default

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.

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, private consumption expenditure, inflation, development of housing prices 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.

56. Financial assets and financial liabilities, continued

The Bank has six different exposure specific PD models for individuals: mortgages, consumer loans, auto loans, guarantees, loans to individuals for work purposes and other loans. The Bank has a different model or rating logic for the following corporate portfolios – large corporates, retail SMEs, holding companies, financial institutions (external ratings), municipalities, state related entities and cooperatives.

Loss given default

Each credit facility is assigned an LGD. 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 cure rate is modeled on the Group's historical data of assets returning to performing status after being in default without loss. The expected recovery is the outcome of the Group's collateral allocation algorithm which takes into account the seniority of debt and collateral type. Haircuts are applied to different types of collaterals based on expert judgment, supported by historical data, and take into account costs and the time value of money. Different haircuts are applied for different macro-economic scenarios in the ECL calculations. In some instances, assets are considered to be fully covered by collateral after haircut application and therefore carry no ECL. The recovery rate for the unsecured part of the exposure is based on expert judgment, taking into account historical loss experience.

The cut-off period for cure is taken to be 18 months from default, which means that a return to non-default after that period is not considered a cure. Furthermore, cure is defined on a portfolio level instead of on a loan level i.e. the same level as the PD models. In this version, statistical cure rate models have been created for the largest portfolios – mortgages, consumer loans and large corporates and retail SMEs. As the explanatory variables in the statistical cure rate models can be related to variables in PD models, this change prompts a consideration of PD-cure correlation. The correlation effects are taken into account in the Bank's ECL calculations. Furthermore, long-run average cure rate models using macro-economic variables have been created. The models can be used to assess cure rate under different economic conditions to be able to apply different cure rates for different economic scenarios given different economic conditions.

Exposure at default

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 takes 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.

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 the reporting date, the Group determines 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 0 or 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 0 or 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).

56. Financial assets and financial liabilities, continued

Exposures in default

Exposures in default at each reporting date, according to the Group's definition, are considered to be credit impaired.

The amount of the loss impaired is the difference between the assets' gross carrying value and the present value of estimated future cash flow. In some instances, the impairment of exposures is zero due to collateral coverage.

Impairment losses are recognized in net impairment, see note 42. Any decreases in impairment loss amounts are 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 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 procedures for extensions do not limit the Group's exposure to credit losses to the contractual 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 assigns its best estimate of the 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. Among other variables considered are GDP growth, private consumption expenditure, inflation, development of housing prices and benchmark interest rates. The average cure is also correlated with unemployment rate, depending on portfolio, and 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 i.e. the bankruptcy of the borrower or an ineffective attachment or distraint. Collateralized loans are generally written of when the realization of collateral have been received. After write-off, exposures continue to be subject to collection activities in accordance with Icelandic law.

56. Financial assets and financial liabilities, continued

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 made. Modifications which are performed for credit reasons, primarily related to troubled debt restructurings, are generally treated as modifications of the original financial asset unless modifications are significant. Significant modifications 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 PD, 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.

57. Hedge accounting

From the applying of IFRS 9 from 1 January 2018, the Group has chosen to continue to apply the hedge accounting requirements of IAS 39, in line with exemption from IFRS 9. However, the Group will provide the expanded disclosures on hedge accounting introduced by IFRS 9's amendments to IFRS 7, as the accounting policy election does not provide an exemption from the new disclosure requirements under IFRS 7.

The Group applies fair value hedge accounting with respect to designated hedging relationship of certain fixed-rate foreign currency denominated notes issued by the Bank as the hedged items and certain foreign currency denominated interest rate swaps as the hedging instruments. The Group recognizes the changes in fair value of the interest rate swaps together with changes in the fair value of bonds attributable to interest rate risk immediately in profit or loss in the line item of Note 10, Net gain on fair value hedge of interest rate swap. Calculated accrued interest on both swaps and bonds are included in the line item of Note 7, Interest expense.

Other derivatives, not designated in a qualifying hedge relationship, are used to manage its exposure to foreign currency, interest rate, equity market and credit risk. The financial instruments used include, but are not limited to, interest rate swaps, cross-currency swaps, forward contracts, futures, options, credit swaps and equity swaps.

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If the hedging derivative expires or is sold, terminated or exercised, or the hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. Any adjustments, up to the point of discontinuation, to a hedged item for which the effective interest method is used, is amortized to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

58. Cash and cash equivalents

Cash and cash equivalents in the Statement of Cash Flows consist of cash, demand deposits with the Central Bank and demand deposits with other credit institutions. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition. Cash and cash equivalents are carried at amortized cost in the Statement of Financial position.

59. Loans

Loans are financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near term. Loans include loans provided by the Group to credit institutions and to its customers, participation in loans from other lenders and purchased loans.

Loans are initially measured at fair value plus incremental direct transaction costs, and subsequently measured at their amortized cost using the effective interest method.

When the Group is the lessor in a lease agreement that transfers substantially all of the risks and rewards incidental to ownership of the asset to the lessee, the arrangement is classified as a capital lease and a receivable equal to the net investment in the lease is recognized and presented within loans.

When the Group purchases an asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date reverse repo or stock borrowing, the arrangement is accounted for as a loan, and the underlying asset is not recognized in the Group's Consolidated Financial Statements.

60. Derivatives

A derivative is a financial instrument or other contract, the value of which changes in response to a change in an underlying variable, such as share, commodity or bond prices, an index value or an exchange or interest rate, which requires no initial net investment or initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors and which is settled at a future date.

Derivatives are recognized at fair value. Fair value changes are recognized in the Income Statement. Changes in fair values of derivatives are split into interest income, foreign exchange differences and net financial gain or loss. Interest income is recognized on an accrual basis. Derivatives with positive fair values are recognized as Financial instruments and derivatives with negative fair values are recognized as Financial liabilities at fair value.

61. Intangible assets

Goodwill and infrastructure

Goodwill and infrastructure that arises on the acquisition of subsidiaries is presented with intangible assets. Subsequent to initial recognition goodwill and infrastructure is measured at cost less accumulated impairment losses.

Customer relationship and related agreements

Customer relationship and related agreements are measured at cost less any accumulated impairment losses.

Software

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

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

Amortization of intangible assets

Amortization of intangible assets is recognized in the Income Statement on a straight-line basis over the estimated useful life, from the date that it is available for use. The estimated useful life of intangible assets for the current and comparative periods is three to ten years.

62. Investment property

An investment property is a property which is held either to earn rental income or for capital appreciation or for both.

Investment property is initially measured at cost and subsequently at fair value. Gains or losses arising from changes in the fair values of investment properties are included in the Income Statement.

63. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than assets held for sale, investment property and deferred tax assets, are reviewed at each reporting date to determine, whether there is any indication of impairment. If any such indication exists then the asset's recoverable amount is estimated. The recoverable amount of intangible assets is assessed annually.

An impairment loss is recognized if the carrying amount of an asset exceeds its recoverable amount. Impairment losses are recognized in profit or loss.

The recoverable amount of an asset is the greater of its value in use and its fair value less cost to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

An impairment loss in respect of other assets, where impairment losses have been recognized in prior periods, are assessed at each reporting date for any indications that the loss has decreased or no longer exists. An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss had been recognized.

64. Deposits

Deposits are initially measured at fair value plus transaction costs, and subsequently measured at their amortized cost using the effective interest method.

65. Borrowings

Borrowings are measured at amortized cost with any difference between cost and redemption amount being recognized in the Income Statement over the period of the borrowings on an effective interest basis. Accrued interest is included in the carrying amount of the borrowings.

66. Subordinated liabilities

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within both Tier 1 and Tier 2, based on terms of each instrument. The Group may only retire subordinated liabilities with the permission of the FSA.

Subordinated liabilities are recognized initially at fair value less attributable transaction costs. Subsequent to initial recognition, subordinated liabilities are stated at principal amount due plus accrued interest, which is recognized in the Income Statement based on the contractual terms of the borrowing.

67. Assets and disposal groups held for sale

The Group classifies a Asset or disposal group as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the asset or disposal group must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such asset or disposal group and the sale must be highly probable.

Immediately before classification as held for sale, the measurement of the qualifying assets and all assets and liabilities in a disposal group is brought up-to-date in accordance with applicable IFRS. Then, on initial classification as held for sale, Assets and disposal groups are recognized at the lower of carrying amount and fair value less costs to sell. Impairment losses on initial classification as held for sale are included in the Income Statement, even when there is a revaluation. The same applies to gains and losses on subsequent remeasurement. Revaluation through the reversal of impairment in subsequent periods is limited so that the carrying amount of the held for sale, Assets or disposal groups does not exceed the carrying amount that would have been determined had no impairment loss been recognized in prior years.

68. Other assets and other liabilities

Property and equipment

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses. When parts of an item of property and equipment have different useful lives, they are accounted for as separate items of property and equipment.

Subsequent expenditure is capitalized only when it is probable that the future economic benefits of the expenditure will flow to the Group. Ongoing repairs and maintenance are expensed as incurred.

The depreciable amount of property and equipment is determined after deducting its residual value. Depreciation is charged to the Income Statement on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives are as follows:

Real estates	33 years
Equipment	3-15 years

The depreciation methods, useful lives and residual values are reassessed annually.

Right-of-use asset and lease liability

The Group assesses whether a contract is or contains a lease, at inception of the contract. The Group recognises a right-of-use asset and a corresponding lease liability with respect to all lease arrangements in which it is the lessee, except for short-term leases and leases of low value assets. For these leases, the Group recognises the lease payments as an operating expense on a straight-line basis over the term of the lease. The lease liability is initially measured at the present value of the lease payments that are not paid at the commencement date, discounted by using the Group's incremental borrowing rate. The right-of-use assets comprise the initial measurement of the corresponding lease liability. They are subsequently measured at cost less accumulated depreciation.

Other assets and other liabilities

Other assets and other liabilities are stated at cost less impairment.

Technical provision

Estimate is made in accordance with Solvency II rules. Data from the company's claim system are extrapolated to predict the final amount of the claims that will be paid at the end of the reporting period with corresponding expected payments from reporting date until the settlement of claims that occurred prior to the reporting date. In addition, estimation of settlement cost, risk and other factors is made in accordance with the instructions in Solvency II rules. This approach is consistent with the valuation of insurance liabilities in IFRS 4.

69. Equity

Dividends

Dividends on shares are recognized in equity in the period in which they are approved by Arion Bank's shareholders.

Reserve for investments in subsidiaries and associates

According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted shareholding equity reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the shareholding equity reserve shall be released and the amount transferred to retained earnings.

Reserve for investments in securities

According to the Financial Statements Act No. 3/2006 fair value changes of financial assets from the initial reporting, shall be transferred from retained earnings to a fair value equity reserve, net of tax. The fair value equity reserve is not subject to dividend payments. The fair value equity reserve shall be released in accordance with fair value changes recognized when financial asset is sold or redeemed or the assumptions for the fair value change is no longer in force.

Reserve due to capitalized development cost

According to the Financial Statements Act No. 3/2006 entities that capitalize development costs shall transfer a corresponding amount from retained earnings to a separate reserve. The reserve is not subject to dividend payments. The reserve shall be eliminated in an amount corresponding to the annual depreciation of the capitalized development cost. The reserve shall be released if the asset is sold or fully depreciated.

Financial assets at fair value through OCI

Unrealized fair value changes net of tax for assets held at fair value through other comprehensive income. The fair value reserve is released in correlation with realization of gains or losses of financial assets at derecognition.

69. Equity, continued

Statutory reserve

According to the Icelandic Companies Act No. 2/1995 at least 10% of the profit of the Group which is not devoted to meeting losses from previous years and is not contributed to other legal reserves must be contributed to the statutory reserve until it amounts to 10% of the share capital. When that limit has been reached the contribution must be at least 5% of the profit until the statutory reserve amounts to 25% of the share capital of the Bank.

Foreign currency translation reserve

The foreign currency translation reserve comprises all foreign exchange differences arising from the translation of the Consolidated Financial Statements of foreign operations.

70. Earnings per share

Earnings per share are calculated by dividing the net earnings attributable to the shareholders of Arion Bank hf. by the weighted average number of ordinary shares outstanding during the year.

71. Financial guarantees

In the ordinary course of business, the Group gives financial guarantees, consisting of letters of credit, guarantees and acceptances. Financial guarantees are initially recognized in the Consolidated Financial Statements at fair value, being the premium received. Subsequent to initial recognition, the Group's liability under each guarantee is measured at the higher of the amount initially recognized less, when appropriate, cumulative amortization recognized in the Income Statement, and the best estimate of expenditure required to settle any financial obligation arising as a result of the guarantee. Any increase in the liability relating to financial guarantees is recorded in the Income Statement. The premium received is recognized in the Income Statement in Net fees and commission income on a straight line basis over the life of the guarantee.

72. Fiduciary activities

The Group provides asset custody, asset management, investment management and advisory services to its clients. These services require the Group to make decisions on the treatment, acquisition or disposal of financial instruments. Assets in the Group's custody are not reported in its Statement of Financial Position.

73. Employee benefits

All entities with employees within the Group have defined contribution plans. The entities pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid. The contributions are recognized as an expense in the Income Statement when they become due. The Group does not operate any pension fund which confers pension rights.

74. Standards issued but not yet effective

New standards, amendments to standards and interpretations have been issued but are not yet effective for the year ended 31 December 2020, and have not been applied in preparing these Consolidated Financial Statements. Relevant to the Group's reporting is IFRS 17 Insurance contracts.

IFRS 17 Insurance Contracts

IFRS 17 Insurance Contracts, is comprehensive new accounting standard for insurance contracts covering recognition and measurement, presentation and disclosure. IFRS 17 applies to all types of insurance contracts (i.e., life, non-life, direct insurance and re-insurance). The overall objective of IFRS 17 is to provide an accounting model for insurance contracts that is more useful and consistent for insurers. IFRS 17 is effective for reporting periods beginning on or after 1 January 2023, with comparative figures required. This standard will be applicable to the Group‘s subsidiary Vördur, which is currently assessing the potential effect of the standard.

5-year overview

Income Statement

	2020	2019	2018	2017	2016
Net interest income	31,158	30,317	29,319	28,920	29,900
Net fee and commission income	11,642	9,950	10,350	10,211	13,978
Net insurance income	3,071	2,886	2,589	2,093	1,395
Net financial income	2,745	3,212	2,302	4,045	5,162
Share of profit of associates and net impairment	-	756	27	(927)	908
Other operating income	2,148	877	1,584	2,521	3,203
Operating income	50,764	47,998	46,171	46,863	54,546
Salaries and related expense	(12,332)	(14,641)	(14,278)	(13,602)	(16,659)
Other operating expense	(12,109)	(12,222)	(12,000)	(9,291)	(13,881)
Operating expenses	(24,441)	(26,863)	(26,278)	(22,893)	(30,540)
Bank levy	(1,301)	(2,984)	(3,386)	(3,172)	(2,872)
Net impairment	(5,044)	(382)	(3,525)	312	7,236
Earnings before income tax	19,978	17,769	12,982	21,110	28,370
Income tax expense	(3,231)	(3,714)	(4,046)	(5,966)	(6,631)
Net earnings from continuing operations	16,747	14,055	8,936	15,144	21,739
Discontinued operations, net of tax	(4,278)	(12,955)	(1,159)	(725)	-
Net earnings	12,469	1,100	7,777	14,419	21,739

Statement of Financial Position

Assets

	2020	2019	2018	2017	2016
Cash and balances with Central Bank	42,136	95,717	83,139	139,819	87,634
Loans to credit institutions	28,235	17,947	56,322	86,609	80,116
Loans to customers	822,941	773,955	833,826	765,101	712,422
Financial instruments	227,251	117,406	114,557	109,450	117,456
Investment property	6,132	7,119	7,092	6,613	5,358
Investments in associates	891	852	818	760	839
Intangible assets	9,689	8,367	6,397	13,848	11,057
Tax assets	2	2	90	450	288
Assets and disposal groups held for sale	16,811	43,626	48,584	8,138	4,418
Other assets	18,618	16,864	13,502	16,966	16,436
Total Assets	1,172,706	1,081,855	1,164,327	1,147,754	1,036,024

Liabilities and Equity

	2020	2019	2018	2017	2016
Due to credit institutions and Central Bank	13,031	5,984	9,204	7,370	7,987
Deposits	568,424	492,916	466,067	462,161	412,064
Financial liabilities at fair value	5,240	2,570	2,320	3,601	3,726
Tax liabilities	4,262	4,404	5,119	6,828	7,293
Liabilities associated with disposal groups held for sale	16,183	28,631	26,337	-	-
Other liabilities	32,714	32,697	30,107	57,062	54,094
Borrowings	298,947	304,745	417,782	384,998	339,476
Subordinated liabilities	36,060	20,083	6,532	-	-
Total liabilities	974,861	892,030	963,468	922,020	824,640
Shareholders' equity	197,672	189,644	200,729	225,606	211,212
Non-controlling interest	173	181	130	128	172
Total equity	197,845	189,825	200,859	225,734	211,384
Total Liabilities and Equity	1,172,706	1,081,855	1,164,327	1,147,754	1,036,024

Valitor hf. was classified as disposal group held for sale in 2018, see Note 29. Comparative figures for 2016 have not been restated.

Arion Bank Consolidated Financial Statements 2020 91 Amounts are in ISK millions

Appendix
Unaudited

Corporate Governance Statement of Arion bank

for 2020

Good corporate governance helps to foster open and honest relations between the Board of Directors, shareholders, customers and other stakeholders, such as the Bank's employees and the general public. Corporate governance also provides the foundations for responsible management and decision-making, with the objective of generating lasting value. The Board of Directors places great importance on good corporate governance and re-evaluates its governance practices regularly on the basis of recognized guidelines on corporate governance.

The Corporate Governance Statement of Arion Bank hf. (Arion Bank or the Bank) is based on the legislation, regulations and recognized guidelines which are in force at the time the Bank's financial statement is adopted by the Board of Directors.

Excellence in corporate governance

Arion Bank was recognized as a company which has achieved excellence in corporate governance following a formal assessment based on the Icelandic Guidelines on Corporate Governance issued by the Icelandic Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland, initially in December 2015 and again in April 2019. This recognition was granted following an in-depth assessment by an independent party of corporate governance at the Bank, including governance by the Board of Directors, sub-committees and management, performed by KPMG ehf. The recognition applies for three years at a time.

Compliance with guidelines on good corporate governance

When it comes to governance arrangements, Arion Bank applies the EBA Guidelines on Internal Governance (EBA/GL/2017/11), in line with requirements found in Regulation (EU) 1093/2010 and Act 24/2017, on European Financial Supervision. The Guidelines are available on the website of the Financial Supervisory Authority of the Central Bank of Iceland.

Furthermore, according to the Financial Undertakings Act No. 161/2002 Arion Bank is obliged to comply with recognized guidelines on corporate governance. The Bank complies with the fifth edition of the Icelandic Guidelines on Corporate Governance issued by Iceland Chamber of Commerce, SA – Business Iceland and Nasdaq Iceland, published in May 2015 and viewable on the website www.leidbeiningar.is. According to the guidelines a company shall state whether it has deviated from the guidelines, if so, which parts and also explain why it has done so. The Bank complies with the guidelines with two deviations:

Article 5.1.2. states that the rules of procedure of sub-committees of the Board shall be posted on the Bank's website. The rules of the Board Credit Committee have not been published on the Bank's website with respect to their nature.

The final sub-paragraph of article 5.4.5 states that the role of a remuneration committee shall include taking an independent stance on the effect of wages on the Company's risk exposure and risk management, in cooperation with the Company's Audit Committee. In line with, inter alia, the EBA Guidelines on Internal Governance and article 78(3) of the Act on Financial Undertakings, this role falls to the Board's Remuneration Committee in cooperation with the Board's Risk Committee.

The role of the Nomination Committee at Arion Bank is to promote good corporate governance and to facilitate informed decision-making by shareholders when selecting Board members to ensure that Board members have wide and versatile qualifications and experience. The Committee has an advisory role regarding the election of Board members and makes a proposal on their remuneration. At the Bank's annual general meeting on 17 March 2020, two members of the Nomination Committee were appointed, Sam Taylor and Júlíus Þorfinnsson. According to the Rules of Procedure for the Nomination Committee, the third member of the Committee shall be the Chairman of the Board of Directors or another Board Member appointed by the Board.

Legal framework for the Bank's operation

Arion Bank is a financial institution which operates in accordance with the Financial Undertakings Act No. 161/2002. Acts of law which also apply to the Bank's operations include e.g. the Securities Transactions Act No. 108/2007, Act on Undertakings for Collective Investment in Transferable Securities (UCITS), Investment Funds and Professional Investment Funds No. 128/2011, Act on Payment Services No. 120/2011, Act on Measures Against Money Laundering and Terrorist Financing No. 140/2018, Act on Consumer Mortgages No. 118/2016, Consumer Loans Act No. 33/2013, Competition Act No. 44/2005 and Public Limited Companies Act No. 2/1995.

Arion Bank is a strongly capitalized bank, the purpose of which is to excel by offering smart and reliable financial solutions which create future value for our customers, shareholders and society as a whole. The Bank is listed on Nasdaq Iceland and Nasdaq Sweden. The Bank has also issued financial instruments which have been admitted for trading on regulated securities markets in Iceland and Luxembourg. The Bank is therefore subject to the disclosure requirements of issuers pursuant to the Securities Transactions Act and the rules of the relevant stock exchanges.

The Financial Supervisory Authority of the Central Bank of Iceland (FSA) supervises the operations of Arion Bank in accordance with the provisions of Act No. 87/1998 on the Official Supervision of Financial Operations. Further information on the FSA and an overview of the legal and regulatory framework applicable to the Bank, as well as FSA guidelines and guidelines issued by European Financial Supervisory institutions, can be seen on the FSA's website, **www.cb.is/financial-supervision/**.

Numerous other pieces of legislation apply to the operations of financial undertakings.

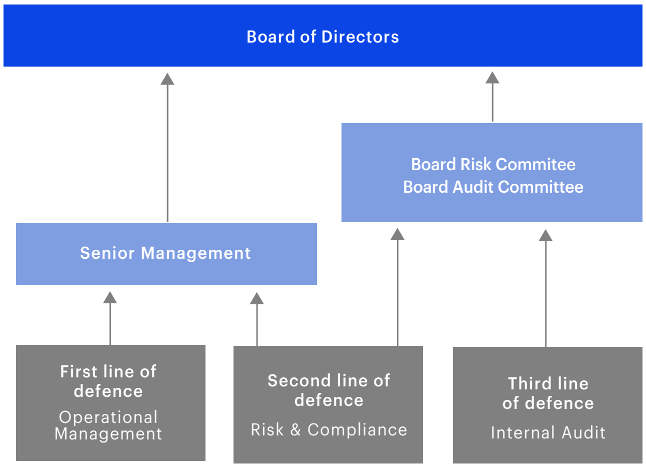
Internal controls, auditing and accounting

Internal control

Internal control at Arion Bank is organized into three lines of defense with the aim of ensuring effectiveness, defining responsibility and coordinating risk management. This structure is also designed to foster a sense of risk awareness and responsibility among all employees of the Bank.

The set-up distinguishes between the following roles:

- People who bear responsibility for risk and manage risk
- People who monitor and check internal controls
- People who perform independent surveys of the effectiveness of internal controls



The first line of defense is made up of people who have day-to-day supervision of operations and its organization. They are responsible for establishing and maintaining effective internal controls and managing risk in day-to-day operations. This involves identifying and evaluating risk and putting in place appropriate countermeasures to reduce risk. The first line of defense is responsible for supervising the implementation of internal rules and processes in compliance with the law, regulations and the Bank's strategy and it must ensure that all actions are in compliance with established procedures and that corrective action is taken if any deficiencies are detected.

The second line of defense is set up to ensure that the first line of defense has established adequate internal controls which work as intended. Risk Management and Compliance are the main participants in the second line of defense, although other units may also be assigned specific monitoring roles.

The third line of defense is Internal Audit, which keeps the Board and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Compliance

Compliance is an independent control function which reports directly to the CEO and works in accordance with a special charter from the Board.

The main role of Compliance is to ensure that the Bank has in place proactive measures to reduce the risk of rules being breached in the course of its activities. Compliance is also responsible for coordinating the Bank's measures against money laundering and terrorist financing to reduce the risk of the Bank's services being used for illegal purposes. Furthermore, the Compliance Officer has the role of the Bank's Data Protection Officer. The Bank has adopted a data protection statement which can be seen on the Bank's website.

The duties of Compliance are carried out under a risk-based compliance plan approved by the Board of Directors, including a monitoring and training schedule for employees which addresses the laws and rules under which the Bank operates. Compliance provides the Board of Directors with a quarterly report on its activities.

Further information can be found on the Bank's website.

Risk Management

A central feature of the activities of all financial companies is carefully calculated risk-taking according to a predetermined strategy. Arion Bank thus takes risk compatible with its risk appetite, which is regularly reviewed and approved by the Board of Directors. The Bank's risk appetite, set by the Board, is translated into exposure limits and targets that are monitored by Risk Management. The Board is responsible for Arion Bank's internal capital adequacy assessment process, the main objective of which is to ensure that Arion Bank understands its risk profile and has systems in place to assess, quantify and monitor its total risk exposure.

The Bank's Risk Management division is headed by the Chief Risk Officer. It is independent and centralized and reports directly to the CEO and operates in accordance with a special charter from the Board. Risk Management comprises three departments whose role is to analyze, monitor and regularly report to the CEO and Board of Directors on the risks faced by the Bank.

Further information on risk management and capital management is contained in the Bank´s annual report and the Bank's risk report.

Internal Audit

The Internal Auditor is appointed by the Board of Directors and reports directly to the Board. The Board sets the Internal Auditor a charter which sets out the responsibilities associated with the position and the scope of the work. The role of the Internal Auditor is to provide independent and objective assurance and advice designed to add value and improve the Bank's operations. The scope of the audit is the Bank, its subsidiaries and pension funds serviced by Arion Bank.

Accounting and auditing

The Bank's Finance division is responsible for preparing the accounts and this is done in accordance with the International Financial Reporting Standards (IFRS). The Bank publishes its financial statement on a quarterly basis and management statements are generally submitted to the Board ten times a year. The Board Audit Committee examines the annual financial statement and interim financial statements, while the external auditors review and audit the accounts twice a year. The Board Audit Committee gives its opinion on the accounts to the Board of Directors, which then approves and endorses the accounts.

Cornerstones and code of ethics

Arion Bank's cornerstones is the name used to describe the Bank's core values. The cornerstones are designed to provide guidance when making decisions and in everything else employees say and do. They refer to the Bank's role, attitude and conduct. Arion Bank's cornerstones are; we find solutions, we make a difference, we get things done, and, we say what we mean.

The management and employees of Arion Bank are conscious of the fact that the Bank's activities affect different stakeholders and society at large. The Bank's code of ethics is designed to serve as a key to responsible decision-making at Arion Bank. The code of ethics is approved by the Board of Directors.

Sustainability

Arion Bank's sustainability policy bears the title Together we make good things happen and signifies that the Bank wants to act as a role model in responsible and profitable business practices, taking into account the environment, the economy and the society in which we live and work.

Arion Bank shows its commitment to sustainable banking by making a difference to our customers and performing our role as a financial institution conscientiously and responsibly. Arion Bank takes an active role in our society and its development. Financial institutions are one of the pillars of society and our role is to help our customers, both individuals and companies, reach their goals. We place great importance on doing things fairly with the interests of our customers, employees, investors and the community at heart.

Arion Bank has been a partner of Festa, the Icelandic Center for Corporate Social Responsibility, for several years and since 2014 has been a signatory to the CEO Statement of Support for the Women's Empowerment Principles (UN Women and UN Global Compact). In 2015 the Bank signed the City of Reykjavík and Festa's Declaration on Climate Change and has published its environmental accounts since 2016. Arion Bank has been a signatory to the UN Global Compact, the UN's initiative to encourage businesses to adopt sustainable and socially responsible practices, since the end of 2016. The Bank has also complied with the UN's Principles for Responsible Banking (UN PRI) since the end of 2017. In September 2019 the Bank became a signatory to the UN Principles for Responsible Banking (UN PRB), the goal of which is to align banking with international goals and commitments such as the UN Sustainable Development Goals and the Paris Climate Agreement.

Arion Bank's activities are governed by the provisions of the Annual Accounts Act on non-financial reporting, which, among other things, apply to the status and influence of the company in respect of environmental, social and human resources issues. Non-financial reporting in the annual report is based on the Global Reporting Initiative, GRI Core and the ESG reporting guide for the Nasdaq Nordic and Baltic exchanges.

The Board of Directors has adopted an environment and climate policy. Under the policy the Bank focuses its attention on financing projects on sustainable development and green infrastructure, require that suppliers take into account the environmental and climate impact of their activities and reduce its own greenhouse gas emissions by 40% by 2030.

Further information on sustainability at Arion Bank can be found in the Bank's 2021 Annual Report. Further information can be found on the Bank's website.

Board of Directors and committees

The main duty of the Board of Directors of Arion Bank is to manage the Bank between shareholders' meetings according to applicable laws, regulations and articles of association. The Board tends to those operations of the Bank which are not considered part of the day-to-day business, i.e. it makes decisions on issues which are unusual or of a significant nature. One of the Board's main duties is to supervise the Bank's activities. The Board's work, duties and role are defined in detail in the rules of procedure of the Board of Directors, which have been established on the basis of Article 54 of the Financial Undertakings Act, Article 70 of the Public Limited Companies Act No. 2/1995, FSA Guidelines No. 1/2010, and the articles of association of the Bank. The rules of procedure of the Board of Directors can be found on the Bank's website.

The Board of Directors appoints a Chief Executive Officer who is responsible for the day-to-day operations in accordance with a strategy set out by the Board. The Board of Directors and the Chief Executive Officer shall carry out their duties with integrity and ensure that the Bank is run in a sound and reasonable manner in the interests of the customers, the community, the shareholders and the Bank itself, cf. Article 1 (1) of the Financial Undertakings Act. The Chief Executive Officer shall ensure that the Board receives sufficient support to carry out its duties.

The Board of Directors is generally elected for a term of one year at the Bank's annual general meeting. At Arion Bank's annual general meeting on 17 March 2020, seven Directors and three Alternates were elected to the Board of Directors.

The elected Board Directors have diverse backgrounds and extensive skills, experience and expertise. When electing the Board care is taken to ensure at least 40% representation of each gender among directors and alternates. Currently the Board consists of four men and three women.

Information on the independence of Directors is published on the Bank's website before the annual general meeting or a shareholders' meeting where a Board member is to be elected. The minutes of the annual general meeting and shareholders' meetings are also published on the Bank's website.

The Board of Directors meets at least ten times a year. In 2020 the Board met on 12 occasions. The Chairman of the Board is responsible for ensuring that the Board performs its role in an efficient and organized manner. The Chairman chairs Board meetings and ensures that there is enough time allocated to the discussion of important issues and that strategy issues are discussed thoroughly. The Chairman is not permitted to undertake any other work for the Bank unless part of the normal duties of the Chairman.

According to the Board's Rules of Procedure the Board is permitted to establish committees to discuss particular areas of the Bank's operations. No later than one month following the annual general meeting the Board appoints members to each of its sub-committees and assesses whether it is necessary to appoint external members to certain committees in order to bring in a greater level of expertise. One of the committee members in the Board Audit Committee, Heimir Þorsteinsson, is not a Board member and is independent of the Bank and its shareholders. The Board sub-committees are as follows:

- Board Audit Committee (BAC): The BAC´s main role is to contribute to the high-quality statutory auditing of the Bank and monitor the effectiveness of the Bank's internal quality control, risk management systems and internal audit function, with regard to the Bank's financial reporting. The Committee met seven times in 2020.
- Board Risk Committee (BRIC): The Committee's main role is, inter alia, to evaluate the Bank's risk policy and risk appetite and to have a thorough knowledge of the risk assessments and methods used to manage risk employed by the Bank. Committee members should have the qualifications and experience necessary to be able to discharge their duties including forming the Bank's risk policy and risk appetite. The Committee met 12 times in 2020 and a joint meeting was held with the Board Remuneration Committee.
- Board Credit Committee (BCC): Its main task is to attend to credit issues which exceed the credit limits of its sub-committees. The Committee met 13 times in 2019.
- Board Remuneration Committee (BRC): The Committee's main role is to prepare a remuneration policy for the Bank on an annual basis. It also advises the Board on remuneration to the CEO, Managing Directors, the Compliance Officer and the Chief Internal Auditor, and on the Bank's incentive scheme and other work-related payments. The Bank's remuneration policy shall be examined and approved by a shareholders' meeting annually. The Committee met four times in 2019 and a joint meeting was held with the Board Risk Committee.
- Board Tech Committee (BTC): In late 2020, the Board setup a temporary, ad hoc, tech committee, whose main role is to advice the Board of Directors and the Bank's Senior Management on the Bank's near to medium term development of the Bank's IT function, including IT strategy.

Sub-committees regularly inform the Board of their activities. Furthermore, the Board has access to all material used by the sub-committees and their minutes.

Below is an overview of the attendance of individual Directors and committee member.

Director	Period	Board (12)	BAC (7)	BRIC (12)	BCC (13)	BRC (5)	BTC (1)
Brynjólfur Bjarnason	1 Jan–31 Dec	12	-	-	13	5	-
Herdís D. Fjeldsted[1]	1 Jan–31 Dec	4	2	-	-	2	-
Gunnar Sturluson[2]	1 Jan–31 Dec	12	5[2]	-	13	-	-
Liv Fiksdahl	1 Jan–31 Dec	12	-	-	-	4	1
Renier Lemmens	1 Jan–31 Dec	12	7	12	-	-	1
Paul Horner[3]	1 Jan–31 Dec	12	-	12	7[3]	-	-
Steinunn Kr. Þórðardóttir	1 Jan–31 Dec	12	-	12	13	-	-
Ólafur Ö. Svansson	1 Jan–31 Dec	-	-	-	-	-	-
Sigurbjörg Á. Jónsdóttir[4]	1 Jan–31 Dec	8	5	-	-	3	-
Þröstur Ríkharðsson	1 Jan–31 Dec	-	-	-	-	-	-
Heimir Þorsteinsson[5]	1 Jan–31 Dec	-	7	-	-	-	-

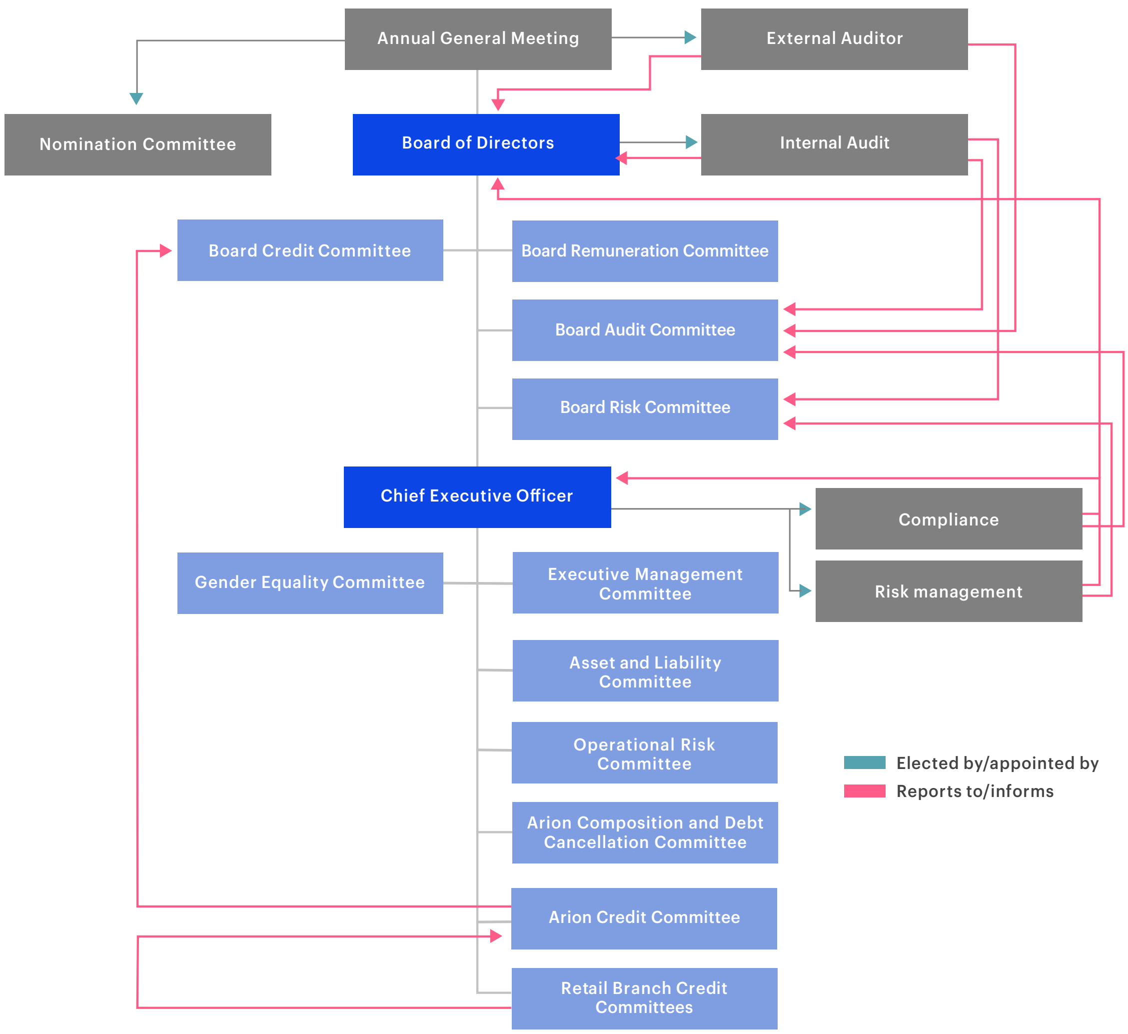
The Board carries out an annual performance appraisal, at which it assesses its work, the necessary number of Board Directors, the Board composition with respect to experience and skills, working procedures and methods, the performance of the CEO, their achievements and the work of the subcommittees with respect to the aforementioned. This appraisal was last performed by the Board during the period October 2020 to January 2021.

[1] Herdís D. Fjeldsted temporarily left the Board when she took over as interim CEO of Valitor.
[2] Gunnar Sturluson was appointed to the BAC in May 2020. He has attended all BAC meetings since joining the Committee.
[3] Paul Horner was appointed to the BCC in May 2020. He has attended all BCC meetings since joining the Committee.
[4] Sigurbjörg Á. Jónsdóttir, alternate Director, has taken a temporary seat on the BAC and BRC in Herdís D. Fjeldsted's absence.
[5] Heimir Þorsteinsson is certified public accountant and appointed as an external member of the BAC.

The Board of Directors of Arion bank

Brynjólfur Bjarnason
Herdís Dröfn Fjeldsted
Gunnar Sturluson
Liv Fiksdahl
Paul Horner
Renier Lemmens
Steinunn Kristín Þórðardóttir

Arion Bank governance overview



Brynjólfur Bjarnason, Chairman

Brynjólfur was born in 1946. He was first elected as a Director at a shareholders' meeting on 20 November 2014. He is not a shareholder of Arion Bank and is an independent Director. Brynjólfur is the Chairman of the Board, Chairman of the Board Remuneration Committee and Chairman of the Board Credit Committee. Brynjólfur graduated with an MBA from the University of Minnesota in 1973 and a cand. oecon. degree in business studies from the University of Iceland in 1971.

Brynjólfur previously worked as the managing director of the Enterprise Investment Fund and as the CEO of Skipti, Síminn and Grandi hf. He has also worked as managing director of the publisher AB bókaútgáfa and was head of the economics department of VSÍ. Brynjólfur has broad experience as a director and has served on numerous boards and been chairman of several of them.

Brynjólfur is an Alternate on the Board of Fergusson ehf. and a board member of Marinvest ehf. and ISAL hf.

Herdís Dröfn Fjeldsted

Herdís was born in 1971. She was first elected as a Director at Arion Bank's annual general meeting on 15 March 2018. She is not a shareholder in Arion Bank and is an independent Director. Herdís is Vice Chairman of the Board, Chairman of the Board Audit Committee and a member of the Board Remuneration Committee. Herdís temporarily took over as CEO of Valitor in March but was appointed to the position on a permanent basis in November 2020. Sigurbjörg Á. Jónsdóttir, alternate Director, has temporarily taken Herdís's seat on the Board.

Herdís graduated with a BSc in business administration with an emphasis on international marketing from the Technical University of Iceland in 2004 and a Master's degree in corporate finance from Reykjavik University in 2011. Herdís is also a certified stockbroker.

Herdís was the CEO of The Icelandic Enterprise Investment Fund (Framtakssjódur Íslands - FSÍ) from 2014 and before that worked as an investment manager at FSÍ. Before joining The Icelandic Enterprise Investment Fund, Herdís worked as a senior investment analyst at Thule Investments. Herdís has served on numerous boards of directors, e.g. as the Chairman of VÍS hf., Chairman of Icelandic Group, Vice-Chairman of Promens and as a board member of Invent Farma, Medicopack A/S, Icelandair Group and Copeinca AS. Herdís is also a member of Exedra. Today, Herdís is a board member at The Icelandic-Canadian Chamber of Commerce.

Gunnar Sturluson

Gunnar was born in 1967. He was first elected as a Director at a shareholders' meeting on 9 August 2019. He is not a shareholder of Arion Bank and is an independent Director. Gunnar is a member of the Board Credit Committee and was also appointed to the Board Audit Committee in May 2020, which he briefly chaired following Herdís D. Fjeldsted's interim appointment as CEO of Valitor and subsequent absence from Board activities.

Gunnar graduated as Cand. Jur from the University of Iceland in 1992, gained an LL.M. degree in Law from the University in Amsterdam in 1995 and received a license to practice before the District Court in Iceland in 1993 and before the Supreme Court in 1999.

Gunnar practiced law at the law firm Málflutningsskrifstofan in 1992–1999 and became partner in 1995. He joined Logos Legal Services in 2000 as a partner and was managing partner in 2001–2013. Gunnar lectured in competition law in 1995–2007 at the University of Iceland, Faculty of Law.

Gunnar has held various directorships, including the board of directors at Gamma hf. in 2017–2019, chairman of the board of directors of the Icelandic National Broadcasting Service (RÚV) 2016–2017, director at the Nordic Arbitration Center, president of the International Federation of Icelandic Horse Associations, chairman of the board of directors of the Icelandic Dance Company 2013–2016 and was voted by the Icelandic parliament to serve on the National Electoral Commission in 2013–2017

Liv Fiksdahl

Liv was born in 1965. She was first elected as a Director at Arion Bank's Annual General Meeting on 20 March 2019. She is not a shareholder of Arion Bank and is an independent Director. Liv is a member of the Board Remuneration Committee and chairs the Board Tech Committee, which was setup in December 2020.

Liv holds a degree in finance and management from Trondheim Business School (today NTNU) in 1986. In 2018, Liv completed programs at Stanford University in big data, strategic decisions and analysis, and the innovative technology leader. She has also completed an advanced management program for executives in management, innovation and technology at Massachusetts Institute of Technology.

Liv is currently a president (associated) within Financial Services at Capgemini Invent, Norway and services on the boards of Scandinavian Airlines SAS AB, Posten Norge AS and Intrum AB. Liv has held various senior roles at DNB and was part of the executive management team for 10 years, and her most recent role was as the Group EVP, CIO/COO, for IT & Operations. Liv has broad experience from DNB, and has held different positions within the bank. Before DNB she had key account roles for the corporate clients within Danske Bank/Fokus Bank, and Svenska Handelsbanken. Liv has served on numerous boards, including BankAxept, Sparebankforeningen, Doorstep, Finans Norge and Trondheim Kommune Bystyret.

Paul Horner

Paul was born in 1962. He was first elected as a Director at a shareholders' meeting on 9 August 2019. He is not a shareholder of Arion Bank and is an independent Director. Paul was appointed to the Board Credit Committee in May 2020 and has chaired the Board Risk Committee since October 2020.

Paul graduated with M.A. Honours in music from the University of Oxford in 1983 and is an associate of the UK Chartered Institute of Bankers.

Paul held various executive and risk management roles at Barclays PLC between 1988 and 2003. In 2003 Paul joined The Royal Bank of Scotland Group and served as an executive and senior manager of Royal Bank of Scotland PLC. He also held various senior risk and general management roles until June 2019.

In 2012 to 2017, Paul was the chief risk officer of Coutts & Co Ltd. and CEO of Coutts & Co Ltd, Zurich, in 2016–2017. Paul was Director of Risk at Ulster Bank DAC, Dublin, and is presently a non-executive director at Allied Irish Banks in London and Coutts & Co Ltd. in Zurich.

Renier Lemmens

Renier was born in 1964. He was first elected as a Director at Arion Bank's Annual General Meeting on 20 March 2019. He is not a shareholder of Arion Bank and is an independent Director. Renier has chaired the Board Audit Committee since October 2020 and is a member of the Board Risk Committee and the Board Tech Committee. Renier is also member of the board of directors of Arion Bank's subsidiary Valitor and chairman of the board risk and monitoring committee at Valitor.

Renier has an MBA from INSEAD and an MSc in computer science from Delft University of Technology.

Renier is currently professor of fintech and innovation at the London Institute of Banking and Finance and the chairman of the board of TransferGo and Divido. Renier previously worked as CEO of Viadeo SA, was partner at Ramphastos Investments, CEO EMEA at PayPal, CEO of Amodo Consumer Finance, COO of international retail & commercial banking at Barclays Bank, consumer finance officer at GE Capital and a partner at McKinsey & Company. Renier has also served on numerous boards, including Revolut, Zenith Bank Ltd., Novum Bank Ltd. as chairman, Antenna Company Ltd., Robin Mobile BV, VoiceTrust BV, Krefima NV as chairman, Arenda BV as chairman, ZA Life Assurance NV, First Caribbean International Bank and chairman and CEO of Budapest Bank.

Steinunn Kristín Þórðardóttir

Steinunn was born in 1972. She was first elected as a Director at Arion Bank's shareholders' meeting on 30 November 2017. She is not a shareholder of Arion Bank and is an independent Director. Steinunn is a member of the Board Risk Committee, which she chaired until October 2020.

Steinunn has a Master's degree in international management from Thunderbird, Arizona and a BA in international business and politics from University of South Carolina.

Steinunn was previously a partner and CEO of Beringer Finance Norway and global head of food and seafood. She founded Akton AS, a management consulting company in Norway in 2010 where she worked as a managing director until 2015. Steinunn worked at Íslandsbanki (later Glitnir) as executive director of International Corporate Credit and later as managing director and head of the bank's UK operations. Steinunn has previously held several Directorships in Europe and was a board member of the Icelandic State Financial Investment (ISFI). Steinunn is the chairman of the board of Acton Capital AS and Akton AS and a board member of Cloud Insurance AS. She is also a board member of the Norwegian-Icelandic Chamber of Commerce. Steinunn is a member of the nomination committee of Síminn.

Alternate directors:

Ólafur Örn Svansson, Supreme Court attorney, Sigurbjörg Ásta Jónsdóttir, lawyer, and Þröstur Ríkharðsson, Supreme Court attorney.

More information on the Board of Directors can be found on the Bank's website.

Communication between the shareholders and the Board of Directors

The main venue at which the Board and the Bank report information to the shareholders and propose decisions to be made is at legally convened shareholders' meetings. The Bank provides an effective and accessible arrangement for communications between shareholders and the Board of Directors between those meetings. Any information sensitive to the market will be released through a MAR press release. As part of the investor relations program, Arion Bank has also arranged quarterly meetings where the CEO, CFO and Investor Relations present the interim financial results.

Chief Executive Officer

Benedikt Gíslason

Benedikt was born in 1974. Benedikt was appointed CEO on 1 July 2019.

Benedikt joined FBA (later Íslandsbanki) in 1998, held a variety of managerial positions at Straumur-Burðarás, was managing director of capital markets at FL Group and was managing director of the investment banking division of MP Bank. Benedikt worked as a senior advisor for Iceland's Ministry of Finance and Economic Affairs and was vice-chairman of a government task force on the liberalization of the capital controls between 2013 and 2016. He served on the board of directors of Kaupthing from 2016 to 2018 and was an advisor to Kaupthing on matters relating to Arion Bank. Benedikt was elected to the Board of Directors of Arion Bank in September 2018 and served on the Board until his appointment as CEO.

Benedikt gained a C.Sc. in mechanical and industrial engineering fromthe University of Iceland in 1998.

Executive Committee

The Bank's Executive Committee consists of the following people and the CEO:

- Ásgeir H. Reykfjörð Gylfason, Deputy CEO and Managing Director of Corporate and Investment Banking
- Birna H. Káradóttir, General Counsel.
- Ida Brá Benediktsdóttir, Managing Director of Retail Banking
- Margrét Sveinsdóttir, Managing Director of Markets
- Stefán Pétursson, Chief Financial Officer
- Styrmir Sigurjónsson, Managing Director of Information Technology & CTO
- Úlfar F. Stefánsson, Chief Risk Officer

More information on the Executive Committee can be found on the Bank's website.

Information on violations of laws and regulations and legal cases

Arion Bank has not been denied registration, authorization, membership or permission to conduct certain business, activity or operations. The Bank has not been subject to withdrawal, revocation or dismissal of registration, authorization, membership or permission. Information on the main legal cases relating to Arion Bank and a settlement with the Financial Supervisory Authority can be found in the notes to the annual financial statement.

The Board of Directors annually reviews and approves the Corporate Governance Statement.

This Corporate Governance Statement was examined and approved at a meeting of the Board of Directors on 10 February 2021.

Arion Bank
Borgartún 19, 105 Reykjavík
Id.: 581008-0150