

Condensed Consolidated  
Interim Financial Statements  
Unaudited

Nine months ended 30 September 2012

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# Endorsement and Statement by the Board of Directors and the CEO

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The unaudited Condensed Consolidated Interim Financial Statements of Íslandsbanki hf. for the period 1 January to 30 September 2012 comprise the Condensed Interim Financial Statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Bank".

## Accounting convention

The unaudited Condensed Consolidated Interim Financial Statements for the period 1 January to 30 September 2012 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union (EU). The Financial Statements are presented in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting.

Profit from the Bank's operations for the period 1 January to 30 September 2012 amounted to ISK 16,221 million, which corresponds to a 16.3% return on equity. Bank equity, according to the Consolidated Financial Position, amounted to ISK 140,045 million at 30 September 2012. The Bank's total official capital ratio, calculated according to the Act on Financial Undertakings, was 23.5% and the Tier 1 ratio was 20.2%. The official capital ratio is based on reviewed retained earnings at 30 June 2012. Capital requirements in excess of the legal minimum of 8% of risk weighted assets are now based on the outcome of the results from the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) conducted by the FME. Current capital ratios are well in excess of both internal and regulatory requirements. The Bank's total assets amounted to ISK 812,711 million at the end of the period.

The Board of Directors draws special attention to the risks relating to the political and legal environment in Iceland where capital controls are still in place. Recent court rulings have affected the operations of the Bank and added to the uncertainty of how to value part of the loan portfolio. The Bank has made appropriate provisions to reflect the risk associated with those court rulings. The Board also notes that the Bank maintains a strong capital base and is therefore well positioned to meet future risks and challenges. The Board refers to Notes 2 and 37 for the principal risks and uncertainties currently faced by the Bank.

To the best of our knowledge, the Condensed Consolidated Interim Financial Statements provide a true and fair view of the Bank's operating profits and its financial position as at 30 September 2012.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's Condensed Consolidated Interim Financial Statements for the period 1 January to 30 September 2012 by means of their signatures.

Reykjavík, 28 November 2012

## Board of Directors:

Friðrik Sophusson, Chairman  
John E. Mack, Vice-Chairman  
Árni Tómasson  
Daniel Levin  
María E. Ingvadóttir  
Neil Graeme Brown  
Marianne Økland

## Chief Executive Officer:

Birna Einarsdóttir

## Condensed Consolidated Statement of Comprehensive Income for the nine months ended 30 September 2012

	Notes	2012 1.7-30.9	2011 1.7-30.9	2012 1.1-30.9	2011 1.1-30.9
Interest income .....		11,916	12,568	42,476	40,123
Interest expense .....		( 4,315)	( 4,720)	( 19,191)	( 15,972)
<b>Net interest income</b>	7	7,601	7,848	23,285	24,151
Net valuation changes on loans and receivables .....	8	713	( 576)	2,782	( 831)
Provision for latent impairment .....	8,23	( 309)	167	( 579)	12
<b>Net valuation changes</b>		404	( 409)	2,203	( 819)
<b>Net interest income after net valuation changes</b>		8,005	7,439	25,488	23,332
Fee and commission income .....		3,744	1,786	10,613	6,188
Fee and commission expense .....		( 1,466)	( 433)	( 3,909)	( 1,822)
<b>Net fee and commission income</b>		2,278	1,353	6,704	4,366
Net financial income (expenses) .....	9-10	223	131	2,099	( 337)
Net foreign exchange gain .....	11	665	72	1,544	408
Other net operating income .....	12	226	312	815	968
<b>Other net operating income</b>		1,114	515	4,458	1,039
<b>Total operating income</b>		11,397	9,307	36,650	28,737
Administrative expenses .....	13-14	( 5,271)	( 4,378)	( 17,888)	( 13,752)
Contribution to the Depositors' and Investors' Guarantee Fund .....		( 272)	( 252)	( 798)	( 684)
<b>Profit before tax</b>		5,854	4,677	17,964	14,301
Income tax .....	15	( 1,465)	( 1,030)	( 4,463)	( 3,097)
Bank tax .....		( 224)	( 165)	( 631)	( 509)
<b>Profit for the period from continuing operations</b>		4,165	3,482	12,870	10,695
Profit from discontinued operations, net of income tax .....		432	( 198)	3,351	651
<b>Profit for the period</b>		4,597	3,284	16,221	11,346

The notes on pages 9 to 40 are an integral part of these Condensed Consolidated Interim Financial Statements

## Condensed Consolidated Statement of Comprehensive Income for the nine months ended 30 September 2012 (continued)

	Notes	2012 1.7-30.9	2011 1.7-30.9	2012 1.1-30.9	2011 1.1-30.9
<b>Other comprehensive income</b>					
Foreign currency translation differences for foreign operations .....		( 33)	12	70	52
<b>Other comprehensive income for the period</b>		( 33)	12	70	52
<b>Total comprehensive income for the period</b>		4,564	3,296	16,291	11,398
<b>Attributable to:</b>					
Equity holders of Íslandsbanki hf. ....		4,496	3,336	16,102	11,413
Non-controlling interests .....		101	( 52)	119	( 67)
<b>Profit for the period</b>		4,597	3,284	16,221	11,346
Basic earnings per share .....	16	0.45	0.33	1.61	1.14
Diluted earnings per share .....	16	0.45	0.33	1.61	1.14

The notes on pages 9 to 40 are an integral part of these Condensed Consolidated Interim Financial Statements

## Condensed Consolidated Statement of Financial Position as at 30 September 2012

	Notes	30.9.2012	31.12.2011
<b>Assets</b>			
Cash and balances with Central Bank .....	6,17	87,059	57,992
Derivatives .....	6,18	257	339
Bonds and debt instruments .....	6	52,127	58,662
Shares and equity instruments .....	6	9,878	11,107
Loans to credit institutions .....	6,19-20	60,942	43,655
Loans to customers .....	6,21-22	546,905	564,394
Investments in associates .....	24	912	1,070
Property and equipment .....		5,545	5,276
Intangible assets .....		602	544
Deferred tax assets .....		1,533	2,629
Non-current assets and disposal groups held for sale .....	27	37,528	42,690
Other assets .....	28	9,423	7,557
<b>Total Assets</b>		<b>812,711</b>	<b>795,915</b>
<b>Liabilities</b>			
Financial liabilities .....	6	10,493	9,346
Derivatives .....	6,18	5,005	4,027
Deposits from Central Bank .....	6,29	13	73
Deposits from credit institutions .....	6,29	41,908	62,772
Deposits from customers .....	6,30-31	482,544	462,943
Debt issued and other borrowed funds .....	6,32	64,693	63,221
Subordinated loans .....	6	22,093	21,937
Current tax liabilities .....		306	2,670
Deferred tax liabilities .....		235	17
Non-current liabilities and disposal groups held for sale .....	27	5,080	7,317
Other liabilities .....	33	40,296	37,889
<b>Total Liabilities</b>		<b>672,666</b>	<b>672,212</b>
<b>Equity</b>			
Share capital .....	34	10,000	10,000
Share premium .....	34	55,000	55,000
Other reserves .....		2,731	2,661
Retained earnings .....		71,235	55,133
<b>Total equity attributable to the equity holders of Íslandsbanki hf.</b>		<b>138,966</b>	<b>122,794</b>
Non-controlling interests .....		1,079	909
<b>Total Equity</b>		<b>140,045</b>	<b>123,703</b>
<b>Total Liabilities and Equity</b>		<b>812,711</b>	<b>795,915</b>

The notes on pages 9 to 40 are an integral part of these Condensed Consolidated Interim Financial Statements

## Condensed Consolidated Statement of Changes in Equity for the nine months ended 30 September 2012

	Attributable to equity holders of Íslandsbanki hf.				Total	Non- controlling interests	Total equity
	Share capital	Share premium	Other reserves	Retained earnings			
<b>Equity at 1.1.2011</b>	10,000	55,000	2,498	53,174	120,672	791	121,463
Translation differences for foreign operations .....			52		52		52
Net income recognised directly in equity .....	-	-	52	-	52	-	52
Profit for the period .....				11,413	11,413	( 67)	11,346
Total comprehensive income for the period .....	-	-	52	11,413	11,465	( 67)	11,398
Change in non-controlling interests .....					-	( 785)	( 785)
<b>Equity at 30.9.2011</b>	10,000	55,000	2,550	64,587	132,137	( 61)	132,076
<b>Equity at 1.1.2012</b>	10,000	55,000	2,661	55,133	122,794	909	123,703
Translation differences for foreign operations .....			70		70		70
Net income recognised directly in equity .....	-	-	70		70	-	70
Profit for the period .....				16,102	16,102	119	16,221
Total comprehensive income for the period .....	-	-	70	16,102	16,172	119	16,291
Change in non-controlling interests .....					-	51	51
<b>Equity at 30.9.2012</b>	10,000	55,000	2,731	71,235	138,966	1,079	140,045

The notes on pages 9 to 40 are an integral part of these Condensed Consolidated Interim Financial Statements

## Condensed Consolidated Statement of Cash Flows for the nine months ended 30 September 2012

	Notes	2012 1.1-30.9	2011 1.1-30.9
<b>Cash flows from operating activities:</b>			
Profit for the period .....		16,221	11,346
<b>Adjustments to reconcile profit for the period to cash flows by operating activities:</b>			
Non-cash items included in profit for the period and other adjustments .....		4,989	4,730
Changes in operating assets and liabilities .....		31,009	19,172
Income tax paid .....		( 6,311)	( 2,506)
<b>Net cash provided by operating activities</b>		<b>45,908</b>	<b>32,742</b>
<b>Net cash (used in) investing activities</b>		<b>( 807)</b>	<b>( 526)</b>
<b>Net cash (used in) financing activities</b>		<b>( 162)</b>	<b>( 5,463)</b>
Net increase in cash and cash equivalents .....		44,939	26,753
Effects of exchange rate changes on cash and cash equivalents .....		12	13
Cash and cash equivalents at the beginning of the period .....		78,571	37,152
<b>Cash and cash equivalents at the end of the period</b>		<b>123,522</b>	<b>63,918</b>
<b>Reconciliation of cash and cash equivalents:</b>			
Cash on hand .....	17	2,176	2,011
Cash balances with Central Bank and certificates of deposit .....	17	76,052	49,019
Bank accounts .....	19	45,294	12,888
<b>Total cash and cash equivalents</b>		<b>123,522</b>	<b>63,918</b>

Interest received in period from 1st of January to end of September 2012 was ISK 31.327 million and interest paid in same period 2012 was ISK 21,088 million (amount in 2011 not available). Interest is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 9 to 40 are an integral part of these Condensed Consolidated Interim Financial Statements



# Notes to the Condensed Consolidated Financial Statements

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# Notes to the Condensed Consolidated Financial Statements

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## Accounting policies

### General information

#### 1. The reporting entity

Íslandsbanki hf. is a limited company incorporated and domiciled in Iceland. The unaudited Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2012 comprise Íslandsbanki hf. (the parent) and its subsidiaries (together referred to as "the Bank").

The Condensed Consolidated Interim Financial Statements were authorised for issue by the Board of Directors of Íslandsbanki hf. on 28 November 2012.

#### 2. Basis of preparation

##### 2.1 *Statement of compliance*

The unaudited Condensed Consolidated Interim Financial Statements for the nine months ended 30 September 2012 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS), as adopted by the European Union. The Interim Financial Statements are presented in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting.

The Condensed Consolidated Interim Financial Statements do not include all the information required for annual financial statements and should be read in conjunction with the Consolidated Financial Statements of the Bank and the Risk Book for the year ended 31 December 2011, available at the Bank's website [www.islandsbanki.is](http://www.islandsbanki.is).

##### 2.2 *Basis of measurement*

The unaudited Condensed Consolidated Interim Financial Statements have been prepared on an historical cost basis except for the following items in the statement of financial position: bonds and debt instrument which are measured at fair value, shares and equity instruments which are measured at fair value, derivative financial instruments which are measured at fair value and non-current assets and disposal groups classified as held for sale which are measured at the lower of cost and fair value less cost to sell.

The Condensed Consolidated Interim Financial Statements are presented in Icelandic krona (ISK), which is the functional currency of the Bank, rounded to the nearest million.

##### 2.3 *Significant accounting judgements and estimates*

The preparation of the unaudited Condensed Consolidated Financial Statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses recognised in the Condensed Consolidated Financial Statements. The accounting estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

The accounting estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised and in any future periods affected.

##### 2.4 *Going concern*

The Bank's management has made an assessment of the Bank's ability to continue as a going concern and is satisfied that the Bank has adequate resources to continue its operations for the foreseeable future. Therefore, the financial statements are prepared on a going concern basis.

##### 2.5 *Changes in presentation*

Comparable information in notes 21 and 23 has been changed following a change in the categorisation by the FME of certain entities from a credit institution to a customer in 2011. This reduces impairment allowance for loans to credit institutions by ISK 555 with a corresponding increase in the impairment allowance of investment companies under loans to customers.

Changes have been made in presentation of credit risk notes. These are explained further under note 38. Comparable information has been changes accordingly.

#### 3 Significant accounting policies

The same accounting policies, presentation and methods of computation have been followed in these Condensed Consolidated Interim Financial Statements as were applied in the preparation of the Bank's Consolidated Financial Statements for the year ended 31 December 2011.

# Notes to the Condensed Consolidated Financial Statements

## Business combination

### 4. Changes within the group

#### 4.1 Merger with Kreditkort hf.

##### a) Identification of the business

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

##### b) Identification of the merged assets and liabilities

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

	1.4.2012
Cash and balances with Central Bank .....	37
Loans to customers .....	5,273
Investment in associates .....	9
Property and equipment .....	121
Tax assets .....	121
Other assets .....	82
<b>Assets</b>	<b>5,643</b>
Borrowings .....	4,878
Other liabilities .....	147
<b>Liabilities</b>	<b>5,025</b>
<b>Net identifiable assets and liabilities</b>	<b>618</b>

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

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

#### 4.2 Loss of control of a subsidiary

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

#### 4.3 Aquisition of subsidiaries held exclusively with a view to disposal

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

## Notes to the Condensed Consolidated Financial Statements

### Quarterly statements

5. Operations by quarters:

	Q3*	Q2*	Q1*	Q4*	Q3*
	2012	2012	2012	2011	2011
Net interest income .....	7,601	6,996	8,688	7,074	7,848
Net valuation changes .....	713	3,613	( 1,544)	( 465)	( 576)
Provision for latent impairment .....	( 309)	( 149)	( 121)	64	167
Net fee and commission income .....	2,278	2,324	2,102	1,600	1,353
Net financial income .....	223	553	1,323	2,986	131
Net foreign exchange gain (loss) .....	665	( 225)	1,104	529	72
Other net operating income (expenses) .....	226	294	295	( 74)	312
Administrative expenses .....	( 5,271)	( 6,395)	( 6,222)	( 6,118)	( 4,378)
Impairment of goodwill .....	-	-	-	( 17,873)	-
Contribution to the Depositors' and Investors' Guarantee Fund .....	( 272)	( 201)	( 325)	( 281)	( 252)
Share of profit of associates .....	-	-	-	39	-
Profit (loss) before tax .....	5,854	6,810	5,300	( 12,519)	4,677
Income tax .....	( 1,465)	( 1,546)	( 1,452)	3,022	( 1,030)
Bank tax .....	( 224)	( 200)	( 207)	( 173)	( 165)
Profit (loss) for the period from continuing operations .....	4,165	5,064	3,641	( 9,670)	3,482
Profit (loss) for the period from discontinued operation .....	432	954	1,965	190	( 198)
<b>Profit (loss) for the period</b>	<b>4,597</b>	<b>6,018</b>	<b>5,606</b>	<b>( 9,480)</b>	<b>3,284</b>

\*The half year results were reviewed by the Bank's auditors, with an emphasis on the loan portfolio, but the splits between quarters were not audited.

## Notes to the Condensed Consolidated Financial Statements

### Financial assets and liabilities

6. The following tables show the carrying value of financial assets and financial liabilities according to their IAS39 classification.

#### At 30 September 2012

	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Other amortised cost	Total carrying amount
Cash and balances with Central Bank .....	18	-	-	87,059	-	87,059
<i>Loans and receivables</i>						
Loans to credit institutions .....	20-21	-	-	60,942	-	60,942
Loans to customers .....	22-23	-	-	546,905	-	546,905
<b>Loans and receivables</b>		-	-	694,906	-	694,906
<i>Bonds and debt instruments</i>						
Listed .....		16,418	31,690	-	-	48,108
Unlisted .....			4,019	-	-	4,019
<b>Bonds and debt instruments</b>		16,418	35,709	-	-	52,127
<i>Shares and equity instruments</i>						
Listed .....		1,063	4,182	-	-	5,245
Unlisted .....			4,633	-	-	4,633
<b>Shares and equity instruments</b>		1,063	8,815	-	-	9,878
Derivatives .....	19	257	-	-	-	257
<b>Total financial assets</b>		17,738	44,524	694,906	-	757,168
<i>Financial liabilities</i>						
Derivatives .....	19	5,005	-	-	-	5,005
Deposits from Central Bank .....	30	-	-	-	13	13
Deposits from credit institutions .....	30	-	-	-	41,908	41,908
Deposits from customers .....	31-32	-	-	-	482,544	482,544
Debt issued and other borrowed funds .....	33	-	-	-	64,693	64,693
Subordinated loans .....		-	-	-	22,093	22,093
<b>Total financial liabilities</b>		15,498	-	-	611,251	626,749

## Notes to the Condensed Consolidated Financial Statements

6. Cont'd

At 31 December 2011

	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Other amortised cost	Total carrying amount
Cash and balances with Central Bank .....	18	-	-	57,992	-	57,992
<i>Loans and receivables</i>						
Loans to credit institutions .....	20-21	-	-	43,655	-	43,655
Loans to customers .....	22-23	-	-	564,394	-	564,394
<b>Loans and receivables</b>		-	-	666,041	-	666,041
<i>Bonds and debt instruments</i>						
Listed .....		23,095	31,610	-	-	54,705
Unlisted .....		-	3,957	-	-	3,957
<b>Bonds and debt instruments</b>		23,095	35,567	-	-	58,662
<i>Shares and equity instruments</i>						
Listed .....		1,079	5,207	-	-	6,286
Unlisted .....		-	4,821	-	-	4,821
<b>Shares and equity instruments</b>		1,079	10,028	-	-	11,107
Derivatives .....	19	339	-	-	-	339
<b>Total financial assets</b>		24,513	45,595	666,041	-	736,149
<i>Financial liabilities</i>						
Financial liabilities .....		9,346	-	-	-	9,346
Derivatives .....	19	4,027	-	-	-	4,027
Deposits from Central Bank .....	30	-	-	-	73	73
Deposits from credit institutions .....	30	-	-	-	62,772	62,772
Deposits from customers .....	31-32	-	-	-	462,943	462,943
Debt issued and other borrowed funds .....	33	-	-	-	63,221	63,221
Subordinated loans .....		-	-	-	21,937	21,937
<b>Total financial liabilities</b>		13,373	-	-	610,946	624,319

## Notes to the Condensed Consolidated Financial Statements

### Net interest income

7. Net interest income is specified as follows:	2012 1.7-30.9	2011 1.7-30.9	2012 1.1-30.9	2011 1.1-30.9
<b>Interest income:</b>				
Cash and balances with Central Bank .....	996	388	2,402	882
Loans and receivables .....	10,214	11,654	38,781	37,699
Financial assets held for trading .....	242	182	( 36)	504
Financial assets designated at fair value through profit or loss .....	452	325	1,265	966
Other assets .....	12	19	64	72
<b>Total interest income</b>	<b>11,916</b>	<b>12,568</b>	<b>42,476</b>	<b>40,123</b>
<b>Interest expense:</b>				
Deposits from credit institutions and Central Bank .....	( 166)	( 303)	( 978)	( 1,400)
Deposits from customers .....	( 3,198)	( 2,749)	( 12,693)	( 8,706)
Borrowings .....	( 535)	( 1,273)	( 4,071)	( 4,489)
Subordinated loans .....	( 260)	( 312)	( 839)	( 895)
Financial liabilities held for trading .....	( 46)	( 110)	( 318)	( 288)
Other interest expense .....	( 110)	27	( 292)	( 194)
<b>Total interest expense</b>	<b>( 4,315)</b>	<b>( 4,720)</b>	<b>( 19,191)</b>	<b>( 15,972)</b>
<b>Net interest income</b>	<b>7,601</b>	<b>7,848</b>	<b>23,285</b>	<b>24,151</b>

### Net valuation changes

8. Net valuation changes:	2012 1.7-30.9	2011 1.7-30.9	2012 1.1-30.9	2011 1.1-30.9
<b>Impairment charged to the comprehensive income:</b>				
Specific impairment losses on financial assets .....	( 545)	( 2,013)	( 11,486)	( 12,507)
Impairment of foreign exchange (loss) gain .....	( 226)	325	( 709)	( 4,638)
Net specific impairment losses on financial assets	( 771)	( 1,688)	( 12,195)	( 17,145)
Provision for latent impairment losses .....	( 309)	167	( 579)	12
Total impairment charged to the comprehensive income (see note 23)	( 1,080)	( 1,521)	( 12,774)	( 17,133)
<b>Net valuation changes:</b>				
Income due to revised estimated future cash flow from loans .....	1,258	1,437	14,268	11,676
Net specific impairment losses on financial assets .....	( 771)	( 1,688)	( 12,195)	( 17,145)
Foreign exchange gain (loss) (see note 11) .....	226	( 325)	709	4,638
<b>Net valuation changes on loans and receivables</b>	<b>713</b>	<b>( 576)</b>	<b>2,782</b>	<b>( 831)</b>

Foreign exchange gain from customers with foreign exchange loans and cash flows in ISK is impaired and offset against total foreign exchange gain as per note 11. Foreign exchange loss is recognised after previously impaired gain has been reversed.

## Notes to the Condensed Consolidated Financial Statements

### Net financial income (expenses)

9. Net financial income (expenses) are specified as follows:	2012	2011	2012	2011
	1.7-30.9	1.7-30.9	1.1-30.9	1.1-30.9
Net gain (loss) on financial instruments held for trading .....	114	32	598	( 381)
Net gain on financial instruments designated at fair value through P&L .....	109	99	1,501	102
Net loss on loss of control over subsidiary .....	-	-	-	( 58)
<b>Net financial income (expenses)</b>	<b>223</b>	<b>131</b>	<b>2,099</b>	<b>( 337)</b>

10. Net gain on financial instruments designated at fair value through profit or loss is specified as follows:

Shares .....	181	99	1,456	102
Bonds .....	( 72)	-	45	-
<b>Net gain on financial instruments designated at fair value through P&amp;L</b>	<b>109</b>	<b>99</b>	<b>1,501</b>	<b>102</b>

### Net foreign exchange gain

11. Net foreign exchange gain is specified as follows:	2012	2011	2012	2011
	1.7-30.9	1.7-30.9	1.1-30.9	1.1-30.9
<b>Assets:</b>				
Cash and balances with Central Bank .....	11	( 22)	12	12
Financial assets held for trading .....	189	( 313)	772	( 1,167)
Loans to credit institutions .....	741	( 18)	1,893	1,531
Loans to customers .....	1,126	( 1,016)	2,313	8,526
Other assets .....	63	11	148	23
<b>Total</b>	<b>2,130</b>	<b>( 1,358)</b>	<b>5,138</b>	<b>8,925</b>
<b>Liabilities:</b>				
Deposits from credit institutions .....	108	( 23)	( 45)	( 159)
Deposits from customers .....	( 1,063)	189	( 2,607)	( 2,883)
Subordinated loan .....	( 240)	866	( 156)	( 780)
Other liabilities .....	( 44)	73	( 77)	( 57)
<b>Total</b>	<b>( 1,239)</b>	<b>1,105</b>	<b>( 2,885)</b>	<b>( 3,879)</b>
<b>Unadjusted net foreign exchange gain (loss)</b>	<b>891</b>	<b>( 253)</b>	<b>2,253</b>	<b>5,046</b>
Foreign exchange reversal on loans to customers with ISK cash flow	( 226)	325	( 709)	( 4,638)
<b>Net foreign exchange gain</b>	<b>665</b>	<b>72</b>	<b>1,544</b>	<b>408</b>

### Other net operating income

12. Other net operating income is specified as follows:	2012	2011	2012	2011
	1.7-30.9	1.7-30.9	1.1-30.9	1.1-30.9
Agency fees and service level agreement fees .....	75	89	239	240
Legal cost and fees .....	27	20	69	65
Rental income .....	24	97	76	232
Rental income on foreclosed mortgages .....	64	40	278	185
Other net operating income .....	36	66	153	246
<b>Other net operating income</b>	<b>226</b>	<b>312</b>	<b>815</b>	<b>968</b>



## Notes to the Condensed Consolidated Financial Statements

### Administrative expenses

	2012	2011	2012	2011
	1.7-30.9	1.7-30.9	1.1-30.9	1.1-30.9
13. Administrative expenses are specified as follows:				
Salaries and related expenses .....	2,809	2,140	9,429	7,109
Other administrative expenses .....	2,236	2,066	7,793	6,144
Depreciation and amortisation .....	226	172	666	499
<b>Administrative expenses</b>	<b>5,271</b>	<b>4,378</b>	<b>17,888</b>	<b>13,752</b>

### Salaries and related expenses

	2012	2011	2012	2011
	1.7-30.9	1.7-30.9	1.1-30.9	1.1-30.9
14. Salaries and related expenses are specified as follows:				
Salaries .....	2,182	1,739	7,297	5,753
Pension and similar expenses .....	292	232	984	774
Social security charges .....	318	166	1,023	537
Other .....	17	3	125	45
<b>Salaries and related expenses</b>	<b>2,809</b>	<b>2,140</b>	<b>9,429</b>	<b>7,109</b>

### Effective income tax rate

15. Income tax for the nine month period to 30 September 2012 are calculated at 20%. New tax, special financial activities tax (FAT) is calculated as 6% of taxable profits above ISK 1 billion. The effective income tax rate in the Bank's income statement is 24.8% for the nine months ended 30 September 2012. The difference is specified as follows:

	2012		2011	
	1.1-30.9		1.1-30.9	
Profit before tax.....	17,964		14,301	
Income tax calculated on the profit of the period.....	3,593	20.0%	2,860	20.0%
Special financial activities tax.....	631	3.5%	-	0.0%
Effect of different tax rate in other countries.....	( 11)	(0.1%)	( 10)	(0.1%)
Non-deductable expenses.....	52	0.3%	102	0.7%
Income not subject to tax .....	( 333)	(1.9%)	( 14)	(0.1%)
Correction in accordance with ruling on prior years' taxable income .....	29	0.2%	27	0.2%
Other differences.....	502	2.8%	132	0.9%
<b>Income tax according to the statement of comprehensive income</b>	<b>4,463</b>	<b>24.8%</b>	<b>3,097</b>	<b>21.7%</b>

### Earnings per share

16. Earnings per share are specified as follows:

	2012	2011
	1.1-30.9	1.1-30.9
Net profit of the equity holders of the parent, according to the statement of comprehensive income .....	16,102	11,413
Average outstanding shares:		
Weighted average number of outstanding shares for the period, million .....	10,000	10,000
<b>Average outstanding shares, million</b>	<b>10,000</b>	<b>10,000</b>
<b>Basic earnings per share</b>	<b>1.61</b>	<b>1.14</b>
<b>Diluted earnings per share</b>	<b>1.61</b>	<b>1.14</b>

## Notes to the Condensed Consolidated Financial Statements

### Cash and balances with Central Bank

17. Specification of cash and balances with Central Bank:

	30.9.2012	31.12.2011
Cash on hand .....	2,176	1,976
Balances with Central Bank other than mandatory reserve deposits .....	8,901	14,587
Certificates of deposit .....	67,151	35,059
<b>Included in cash and cash equivalents</b>	<b>78,228</b>	<b>51,622</b>
Mandatory reserve deposits with Central Bank .....	8,831	6,370
<b>Cash and balances with Central Bank</b>	<b>87,059</b>	<b>57,992</b>

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

Certificates of deposit (CDs) are short term instruments issued by the Central Bank at predetermined interest rates. CDs are issued solely to banks and other financial institutions and are not transferable except to other comparable institutions.

### Derivative financial instruments

18. Derivatives held for trading:	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
	30.9.2012	30.9.2012	30.9.2012	30.9.2012
Interest rate swap .....	26	1,300	740	19,100
Cross currency interest rate swaps .....	4	6,755	4,075	54,195
Equity forwards .....	1	79	69	2
Foreign exchange forwards .....	-	-	-	930
Foreign exchange swaps .....	158	3,353	34	1,918
Bond forwards .....	68	2,750	9	1,200
Bond options .....	-	-	78	25,000
<b>Derivatives held for trading</b>	<b>257</b>	<b>14,237</b>	<b>5,005</b>	<b>102,345</b>

Derivatives held for trading:	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
	31.12.2011	31.12.2011	31.12.2011	31.12.2011
Interest rate swap .....	25	3,100	107	10,750
Cross currency interest rate swaps .....	186	11,239	3,690	51,600
Equity forwards .....	6	82	6	30
Foreign exchange forwards .....	45	15,566	98	2,449
Foreign exchange swaps .....	59	4,889	13	1,516
Bond forwards .....	18	955	39	400
Bond options .....	-	-	74	25,000
<b>Derivatives held for trading</b>	<b>339</b>	<b>35,831</b>	<b>4,027</b>	<b>91,745</b>

## Notes to the Condensed Consolidated Financial Statements

### Loans

19. Loans to credit institutions:		30.9.2012	31.12.2011
Money market loans .....		15,648	16,706
Bank accounts .....		45,294	26,949
<b>Loans to credit institutions</b>		<b>60,942</b>	<b>43,655</b>

20. Loans to credit institutions at amortised cost:		30.9.2012		31.12.2011		
	Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance	Carrying amount
Loans .....	60,942	-	60,942	43,655	-	43,655
<b>Loans to credit institutions</b>	<b>60,942</b>	<b>-</b>	<b>60,942</b>	<b>43,655</b>	<b>-</b>	<b>43,655</b>

21. Loans to customers:		30.9.2012	31.12.2011
Loans to customers at amortised cost .....		546,905	564,394
<b>Loans to customers</b>		<b>546,905</b>	<b>564,394</b>

#### 22. Loans to customers at amortised cost:

At 30 September 2012

	Gross amount	Individually assessed impairment allowance	Collectively assessed impairment allowance	Loans less impairment allowance
Loans to customers:				
Individuals .....	248,232	( 6,494)	( 2,205)	239,533
Commerce and services .....	69,439	( 3,830)	( 708)	64,901
Construction .....	21,683	( 2,768)	( 905)	18,010
Energy .....	2,868	( 14)	( 3)	2,851
Financial services .....	214	( 39)	-	175
Government secured customer loan .....	-	-	-	-
Industrial and transportation .....	46,000	( 2,338)	( 583)	43,079
Investment companies .....	21,939	( 4,617)	( 21)	17,301
Public sector and non-profit organisations .....	9,731	( 56)	( 38)	9,637
Real estate .....	95,731	( 13,860)	( 1,212)	80,659
Seafood .....	74,528	( 2,187)	( 41)	72,300
Loans to customers before latent impairment allowance				548,446
Latent impairment allowance .....				( 1,541)
<b>Loans to customers</b>	<b>590,365</b>	<b>( 36,203)</b>	<b>( 5,716)</b>	<b>546,905</b>

## Notes to the Condensed Consolidated Financial Statements

### 22. Cont'd

At 31 December 2011

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

### 23. Financial assets - impairments

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

	Individually assessed	Collectively assessed	Latent	Total
At 1 January 2012 .....	32,735	8,508	915	42,158
Amounts written-off .....	( 9,207)	( 45)	-	( 9,252)
Period adjustments .....	1,837	( 2,140)	47	( 256)
Recoveries of amounts previously written-off .....	1,768	-	-	1,768
Principal credit adjustment .....	( 3,007)	( 725)	-	( 3,732)
Charged to the comprehensive income .....	12,077	118	579	12,774
<b>At 30 September 2012</b>	<b>36,203</b>	<b>5,716</b>	<b>1,541</b>	<b>43,460</b>

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

	2012	2011
<b>Impairment losses charged to the comprehensive income:</b>		
Loans to customers .....	12,774	17,155
Loans to credit institutions .....	-	( 22)
<b>Impairment losses charged to the comprehensive income</b>	<b>12,774</b>	<b>17,133</b>

# Notes to the Condensed Consolidated Financial Statements

## Investment in associates

	30.9.2012	31.12.2011
24. Changes in investments in associates:		
Investment in associates at the beginning of the period .....	1,070	354
Acquisition of shares in associates .....	-	677
Sales of shares in associates .....	( 153)	-
Revaluation .....	( 5)	-
Share of results .....	-	39
<b>Investments in associates at the end of the period</b>	<b>912</b>	<b>1,070</b>

## Investment in subsidiaries

25. Significant subsidiaries:

	Location	Owner-ship
Borgun hf., Ármúla 30, 108 Reykjavík .....	Iceland	61.3%
Íslandssjódir hf., Kirkjusandi 2, 105 Reykjavík .....	Iceland	100%
Midengi ehf., Lækjargötu 12, 155 Reykjavík .....	Iceland	100%
Höfdatorg ehf., Skúlagötu 63, 105 Reykjavík .....	Iceland	72.5%
Hringur eignarhaldsfélag ehf., Digranesvegi 1, 200 Kópavogur .....	Iceland	100%
Allianz Ísland hf., Digranesvegi 1, 200 Kópavogur .....	Iceland	100%
Geysir Green Investment Fund silhf., Hafnargötu 90, Reykjanesbæ .....	Iceland	100%
Island Fund S.A., 5 Allée Scheffer L-2520 Luxembourg .....	Luxembourg	100%
Glacier Geothermal and Seafood Corporation, 7 Times Square, Suite 1605 New York .....	USA	100%
Glacier Securities LLC, 7 Times Square, Suite 1605 New York .....	USA	100%
32 other subsidiaries (SME) .....		

## Related party disclosures

26. Ultimate controlling party

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

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

### Related party transactions

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

All loans to employees are provided on general business terms of the Bank. Included in assets are loans to key management. The amounts are negative where deposits exceed loans to the related party.

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

	30.9.2012	31.12.2011
CEO and Managing Directors (including companies owned by them) .....	( 117)	( 163)
Members of the Board (including companies owned by them) .....	125	( 82)
Associated companies and other related parties .....	( 794)	6,884
<b>Total</b>	<b>( 786)</b>	<b>6,639</b>

Guarantees .....	347	59
Loan commitments, overdraft and credit card commitments .....	1,637	145

Impairment allowances of ISK 210 m. were recognised in the period against balances outstanding with associated companies (same period 2011: ISK 4.6bn).

No share option programmes were operated during the reporting period 2012.

## Notes to the Condensed Consolidated Financial Statements

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

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

	30.9.2012	31.12.2011
Reposessed collateral .....	10,230	10,467
Assets of disposal groups classified as held for sale .....	27,298	32,223
<b>Total</b>	<b>37,528</b>	<b>42,690</b>

Reposessed collateral:

Residential property .....	8,006	7,683
Industrial property .....	65	95
Equipment .....	41	84
Shares and equity instruments .....	1,930	2,182
Other assets .....	188	423
<b>Total</b>	<b>10,230</b>	<b>10,467</b>

Assets of disposal groups classified as held for sale:

	30.9.2012	31.12.2011
Cash .....	1,280	1,212
Investment properties .....	11,350	12,263
Properties .....	595	558
Equipment .....	-	2,299
Receivables .....	2,481	2,090
Tax assets .....	222	697
Inventory .....	1,294	2,056
Assets classified as held for sale .....	6,747	6,129
Other assets .....	3,329	4,919
<b>Total</b>	<b>27,298</b>	<b>32,223</b>

Liabilities associated with assets classified as held for sale:

	30.9.2012	31.12.2011
Payables .....	467	1,237
Deferred tax liabilities .....	640	823
Borrowings .....	2,551	2,352
Other liabilities .....	1,422	2,905
<b>Total</b>	<b>5,080</b>	<b>7,317</b>

## Notes to the Condensed Consolidated Financial Statements

### Other assets

	30.9.2012	31.12.2011
28. Other assets are specified as follows:		
Receivables .....	4,027	3,351
Unsettled securities transactions .....	2,811	2,199
Accruals .....	485	494
Prepaid expenses .....	546	311
Inventory (real estate) .....	534	534
Other assets .....	1,020	668
<b>Other assets</b>	<b>9,423</b>	<b>7,557</b>

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

### Deposits from Central Bank and credit institutions

	30.9.2012	31.12.2011
29. Deposits from Central Bank and credit institutions are specified as follows:		
Repurchase agreements with Central Bank .....	13	73
Deposits from credit institutions .....	41,908	62,772
<b>Deposits from Central Bank and credit institutions</b>	<b>41,921</b>	<b>62,845</b>

### Deposits from customers

	30.9.2012	31.12.2011
30. Deposits from customers are specified by type as follows:		
Demand deposits .....	291,206	259,994
Time deposits .....	191,338	202,949
<b>Deposits from customers</b>	<b>482,544</b>	<b>462,943</b>

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

	30.9.2012		31.12.2011	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises.....	6,266	1%	14,362	3%
Municipalities.....	7,631	2%	7,054	2%
Companies.....	281,898	58%	257,842	55%
Individuals.....	186,749	39%	183,685	40%
<b>Deposits from customers</b>	<b>482,544</b>	<b>100%</b>	<b>462,943</b>	<b>100%</b>

### Debt issued and other borrowed funds

	30.9.2012	31.12.2011
32. Specification of debt issued and other borrowed funds:		
Non-listed issued bonds .....	52,371	55,742
Listed issued bonds .....	8,937	3,855
Loans from credit institutions .....	143	333
Other debt securities .....	3,242	3,291
<b>Debt issued and other borrowed funds</b>	<b>64,693</b>	<b>63,221</b>

## Notes to the Condensed Consolidated Financial Statements

### Other liabilities

33. Specification of other liabilities:	30.9.2012	31.12.2011
Accruals .....	2,821	3,452
Liabilities to retailers for credit card provision .....	16,905	13,585
Provision for effects of court rulings .....	12,415	10,982
Guarantees .....	297	578
Chargeable gain tax .....	685	1,888
Unsettled securities transactions .....	3,462	3,047
Deferred income .....	167	215
Sundry liabilities .....	3,544	4,142
<b>Other liabilities</b>	<b>40,296</b>	<b>37,889</b>

### Equity

34. Authorised share capital of the Bank is 10,000m ordinary shares of ISK 1 each. At 30.9.2012 paid up share capital totalled ISK 65,000m which is the total stated share capital of the Bank.

Total share capital:

	30.9.2012	31.12.2011
Ordinary share capital .....	10,000	10,000
Share premium account .....	55,000	55,000
<b>Total share capital</b>	<b>65,000</b>	<b>65,000</b>

### Off balance sheet items

#### Obligations

35. The Bank has granted its customers guarantees, overdraft facilities and loan commitments. These items are specified as follows:

	30.9.2012	31.12.2011
Financial guarantees .....	9,095	6,893
Undrawn loan commitments .....	13,346	12,592
Undrawn overdrafts .....	20,187	21,449
Credit card commitments .....	28,863	22,202
The Depositors and Investors Guarantee Fund (TIF) – declaration of guarantee .....	3,724	3,724

An amendment to Law 98/1999 on the Depositors' and Investors' Guarantee Fund was passed in Parliament in June 2012. Following the amendment the annual premium will be 0.225% of all eligible deposits. In addition, there will be a variable premium based on Equity, Funding and a Loan Portfolio Analysis (LPA) ratio provided by the FME. The Bank has accordingly made an amendment to its charge to the profit and loss.

### Balance of custody assets

36. Balance of custody assets:

	30.9.2012	31.12.2011
Custody assets .....	821,949	746,574



# Notes to the Condensed Consolidated Financial Statements

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## Contingencies

### 37. Litigation threats

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

#### Netting agreement

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

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

#### Allocation of liens, guarantees and comparable rights

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

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

#### Indexed loans and foreign currency loans

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

On 15 February 2012, the Supreme Court in Iceland passed a ruling (no. 600/2011) that affects the recalculation of loans that are illegally linked to the value of foreign currencies. The ruling states that Act 151/2010, which the Icelandic Parliament passed in December 2010 and instructed banks on how to recalculate foreign currency linked mortgages, violates the provisions of the Icelandic constitution that protects the freedom to hold private property, as the legislator cannot pass a law that retroactively deprives a person of an asset without adequate compensation. Significant uncertainty remains on how the ruling should be interpreted. The Bank made an assessment to the effect that the impact from this court ruling would be a loss of ISK 12.1 billion, however dependent on later rulings. The Bank recognised a provision at year end 2011 and the financial statements therefore reflect the impact of the court rulings at the time. The Bank still maintained a capital ratio above the minimum requirement of 16% set by the Icelandic Financial Supervisory Authority.

In April 2011, the District Court of Reykjavik ruled on a dispute regarding the nature of a financial leasing contract between the Bank and a customer. The court ruled that although the contract had the form of a lease, it was by nature a loan contract, thereby subject to the Interest Law 38/2001. The contract was denominated in foreign currency, and the court further ruled that the contract had an illegal foreign currency indexation, citing the precedent set by the Supreme Court in June 2010. In October 2011, the District Court ruling was confirmed by the Supreme Court. The ruling will affect, by precedent, approximately 4,100 similar contracts with a book value of approximately ISK 10.2 billion. Each affected contract will be recalculated as a result of the ruling.

## Notes to the Condensed Consolidated Financial Statements

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### 37. Cont'd

The ruling on financial leasing contracts does not appear to set new precedent affecting other loan contracts, as the dismissal of the disputed contract's currency indexation is based on the Supreme Court's ruling from June 2010. It should also be noted that although the currency indexation has been deemed illegal, the customer's debt obligation in ISK at the signing of the contract is still valid. The effect of recalculation is minimal for contracts signed before 2004 – 2005.

The Supreme Court set new a precedent in June 2011 by deciding that a Landsbanki loan contract contained an illegal foreign currency indexation. Following this ruling, the Bank has evaluated all corporate contract forms and assessed which forms are affected by the ruling and which are, by the Bank's estimation, legal foreign currency loan contracts. A Supreme Court ruling on the validity of the Bank's contract is expected in January or February 2013.

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

Because of the widespread use of the box form and its predecessors, the impact of the decision is significant, mainly in three ways. Firstly, the 15 February 2012 ruling does not affect the bulk of the mortgage loans as far as further recalculation is concerned. Secondly, the Bank is not obliged to recalculate any similar loans not categorised as mortgage loans. Thirdly, no change is necessary to the method of recalculation in most of the offer loan category.

Furthermore, the Supreme Court decided in June that a loan contract similar to the one in the MótórMax case mentioned above was legal because the lender did actually receive payment in foreign currency.

The Supreme Court passed on the 18 October 2012 a new ruling on the "receipt rule". The ruling supplemented the findings of the previous rule passed by the Supreme Court on 15 February 2012 and gave to a certain extent instructions on how the loans shall be recalculated. In both the Receipt Ruling and the new ruling the amount of an outstanding loan was in dispute and the court found that borrowers that had made payments in line with instructions from the lender should not suffer a higher interest charge for payments already made. Internal and external legal counsel are unanimously in the opinion that the rulings affect loans to various types of borrowers, including individuals, corporate and municipalities and both long and short term loans. The bank has made an announcement to the effect that it will recalculate illegally FX-linked and outstanding as well as paid –up loans in line with the instructions given in the most recent ruling. However, finding that the ruling is based on the Bank being the dominant and expert party in the contractual relationship, the ruling does not necessarily apply to other financial or large companies as counterparts, especially if those conduct their business in part abroad or deal in FX contracts on a regular basis.

Based on the Supreme Court's latest rulings, the Bank will estimate the financial effect of remaining lawsuits. In its estimates, the Bank will take into account that customers have already been offered principal adjustment of foreign currency debt, and that a ruling has been made by the Supreme Court on replacement interest rates. The Bank has divided all foreign currency loans into four categories, depending on the risk of the loans being deemed illegal. The Bank holds provisions for the expected financial effect for the highest risk category. Meanwhile, customers whose contracts are eligible for recalculation will have the option of fixed payments until the recalculations have been completed in the first quarter of 2013.

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

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

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

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

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

# Notes to the Condensed Consolidated Financial Statements

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## 37. Cont'd

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

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

## Risk Management

The Bank is exposed to various risks through its use of financial instruments. Managing these risks is an integral part of the Bank's operations. More information about the Bank's risk management and risk assessment processes is available in the Risk Report 2011.

English version: [www.islandsbanki.is/riskreport](http://www.islandsbanki.is/riskreport)

Icelandic version: [www.islandsbanki.is/ahaettuskysrsla](http://www.islandsbanki.is/ahaettuskysrsla)

## Credit risk

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

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

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

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

The loan portfolio acquired from Glitnir is the largest part of the credit exposure of the Bank. Due to the extraordinary circumstances in the Icelandic economy and the fact that the loan portfolio was acquired at a deep discount, care must be taken when interpreting conventional measures of credit risk.

Changes have been made on the notes on maximum credit exposure and past due but not impaired loans. Maximum credit risk exposure for on-balance sheet assets is now the net carrying amount as reported in the statement of financial position before the latent impairment allowance is subtracted. Loans past due for three days or less are now omitted in the note on past due but not impaired loans.

## 39. Maximum credit exposure

The Bank's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position before the latent impairment allowance is subtracted, see note 23. The maximum exposure for off-balance sheet items is the amount that the Bank might have to pay out against financial guarantees and loan commitments, less provisions the Bank has made because of these items. The maximum credit exposure for a derivative contract is calculated by adding future credit exposure to the market value of the contract as described in Annex III of the European Parliament directive 2006/48/EC (Basel II).

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

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

## Notes to the Condensed Consolidated Financial Statements

### Credit risk exposure

#### 39. Maximum credit exposure

Maximum credit exposure 30.9.2012

	Individuals	Central Governments	Commerce and services	Construction	Energy	Financial services	Government secured customer loan	Industrials and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with Central Bank	-	87,059	-	-	-	-	-	-	-	-	-	-	87,059
Derivatives	20	138	41	62	2	1,218	-	24	22	-	5	105	1,637
Bonds and debt instruments	-	47,114	309	-	-	2,711	-	-	1,096	15	882	-	52,127
Loans to credit institutions	-	-	-	-	-	60,942	-	-	-	-	-	-	60,942
Loans to customers:	239,533	-	64,901	18,010	2,851	175	-	43,079	17,301	9,637	80,659	72,300	548,446
Overdrafts	14,625	-	6,529	3,142	-	37	-	4,055	238	1,113	1,566	1,821	33,126
Credit cards	14,402	-	1,225	141	9	21	-	401	28	205	54	37	16,523
Mortgages	154,998	-	-	-	-	-	-	-	-	-	-	-	154,998
Leases	10,804	-	13,729	2,504	15	18	-	4,313	182	631	1,194	424	33,814
Other loans	44,704	-	43,418	12,223	2,827	99	-	34,310	16,853	7,688	77,845	70,018	309,985
Off-balance sheet item:													
Financial guarantees	1,245	-	1,912	2,020	4	1,501	-	1,207	320	54	329	503	9,095
Undrawn loan commitments	-	-	1,785	666	7,359	-	-	2,503	1	-	-	1,032	13,346
Undrawn overdraft	8,842	-	4,071	1,146	210	1,264	-	2,577	43	812	400	822	20,187
Credit card commitments	23,263	-	2,928	423	15	95	-	728	132	1,018	149	112	28,863
<b>Total maximum credit exposure</b>	<b>272,903</b>	<b>134,311</b>	<b>75,947</b>	<b>22,327</b>	<b>10,441</b>	<b>67,906</b>	<b>-</b>	<b>50,118</b>	<b>18,915</b>	<b>11,536</b>	<b>82,424</b>	<b>74,874</b>	<b>821,702</b>

## Notes to the Condensed Consolidated Financial Statements

39. Cont'd

Maximum exposure 31.12.2011

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

## Notes to the Condensed Consolidated Financial Statements

### 40. Collateral

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

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

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

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

	Real estate	Fishing vessels	Cash & securities	Vehicles & equipment	Other collateral	Total collateral
<b>At 30 September 2012</b>						
Derivatives .....	-	-	620	-	-	620
Loans and commitments to customers:	312,374	58,439	10,864	19,172	14,828	415,677
Individuals .....	189,086	87	698	8,306	-	198,177
Commerce and services .....	21,876	-	193	9,655	4,045	35,769
Construction .....	7,823	-	166	304	3,504	11,797
Energy .....	2,583	-	5	3	123	2,714
Financial services .....	69	-	-	15	-	84
Government secured customer loan .....	-	-	-	-	-	-
Industrial and transportation .....	12,645	-	179	684	5,597	19,105
Investment companies .....	4,020	-	9,061	17	395	13,493
Public sector and non-profit organisations .....	3,980	-	9	66	221	4,276
Real estate .....	65,101	143	307	73	-	65,624
Seafood .....	5,191	58,209	246	49	943	64,638
<b>Total</b>	<b>312,374</b>	<b>58,439</b>	<b>11,484</b>	<b>19,172</b>	<b>14,828</b>	<b>416,297</b>

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

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

## Notes to the Condensed Consolidated Financial Statements

### 41. Credit quality of financial assets

Loans are classified as impaired loans if contractual cash payments are not expected to be fulfilled and if financial restructuring of the obligor is expected to lead to a loss on that particular loan. In most cases, loss is avoided because of the difference between the claim value and the carrying amount resulting from the deep discount of the acquired loan portfolio.

Loans are also classified as impaired if the Bank has made impairments to offset currency movements. This impairment does not signal a loss from the deep discount.

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

	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
<b>At 30 September 2012</b>				
Cash and balances with Central Bank.....	87,059	-	-	87,059
Derivatives .....	1,637	-	-	1,637
Bonds and debt instruments .....	52,127	-	-	52,127
Loans to credit institutions .....	60,942	-	-	60,942
Loans to customers:	437,960	56,608	53,878	548,446
Individuals .....	196,339	35,470	7,724	239,533
Commerce and services .....	49,435	7,116	8,350	64,901
Construction .....	12,824	2,474	2,712	18,010
Energy .....	2,851	-	-	2,851
Financial services .....	111	29	35	175
Government secured customer loan .....	-	-	-	-
Industrial and transportation.....	36,883	2,313	3,883	43,079
Investment companies .....	11,048	2,405	3,848	17,301
Public sector and non-profit organisations .....	8,819	540	278	9,637
Real estate .....	51,982	4,919	23,758	80,659
Seafood .....	67,668	1,342	3,290	72,300
<b>Total</b>	<b>639,725</b>	<b>56,608</b>	<b>53,878</b>	<b>750,211</b>

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

## Notes to the Condensed Consolidated Financial Statements

### 42. Past due but not impaired loans

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

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

	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
<b>At 30 September 2012</b>					
Loans to credit institutions .....	-	-	-	-	-
Loans to customers:					
Individuals .....	5,098	1,910	1,178	27,284	35,470
Commerce and services .....	1,980	236	126	4,774	7,116
Construction .....	288	49	28	2,109	2,474
Energy .....	-	-	-	-	-
Financial services .....	6	-	-	23	29
Government secured customer loan .....	-	-	-	-	-
Industrial and transportation .....	291	115	85	1,822	2,313
Investment companies .....	207	104	319	1,775	2,405
Public sector and non-profit organisations .....	138	16	-	386	540
Real estate .....	279	127	167	4,346	4,919
Seafood .....	124	38	115	1,065	1,342
<b>Total</b>	<b>8,411</b>	<b>2,595</b>	<b>2,018</b>	<b>43,584</b>	<b>56,608</b>

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



## Notes to the Condensed Consolidated Financial Statements

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### 43. Large exposure disclosure

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

When assessing the exposure, both on-balance sheet and off-balance sheet items from all types of financial instruments are included as defined by the FME rules. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) in Law no. 161/2002 on Financial Undertakings, where groups of connected clients are defined. In line with the law, the capital base from the last reviewed financial statements at 30 June 2012 is used to define large exposures.

The Bank has one large exposure to a group of connected clients that amounts to 16% of the Bank's capital base which is below the aggregated 400% limit set by the law. No large exposure exceeds the maximum 25% set by the law.

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

	30.9.2012	
<b>Client groups</b>	Gross	Net
Group 1 .....	70%	0%
Group 2 .....	16%	16%

  

	31.12.2011	
<b>Client groups</b>	Gross	Net
Group 1 .....	56%	0%
Group 2 .....	27%	0%
Group 3 .....	15%	15%

# Notes to the Condensed Consolidated Financial Statements

## Liquidity Risk

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

### Liquidity risk management

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

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

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

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

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

### Maturity analysis 30 September 2012

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Financial liabilities</b>							
Short positions .....	-	10,493	-	-	-	-	10,493
Deposits from Central Bank .....	13	-	-	-	-	-	13
Deposits from credit institutions .....	33,342	3,005	5,630	-	-	-	41,977
Deposits from customers .....	354,595	47,678	37,379	44,769	22,387	-	506,808
Debt issued and other borrowed funds .....	143	2,828	7,589	44,606	18,555	2,724	76,445
Subordinated loans .....	-	-	757	5,978	27,332	-	34,067
Other financial liabilities .....	37,030	1,935	599	-	294	214	40,072
<b>Total financial liabilities</b>	<b>425,123</b>	<b>65,939</b>	<b>51,954</b>	<b>95,353</b>	<b>68,568</b>	<b>2,938</b>	<b>709,875</b>

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

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Off balance sheet liabilities</b>							
Financial guarantees .....	9,095	-	-	-	-	-	9,095
Undrawn loan commitments .....	13,346	-	-	-	-	-	13,346
Undrawn overdrafts .....	20,187	-	-	-	-	-	20,187
Credit card commitments .....	28,863	-	-	-	-	-	28,863
<b>Total</b>	<b>71,491</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>71,491</b>

### Total non-derivative financial liabilities

and off balance sheet liabilities .....	496,614	65,939	51,954	95,353	68,568	2,938	781,366
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The table below shows the contractual cash flow of the Bank's derivative liabilities, i.e. derivatives that have a negative carrying amount at the date of reporting. Derivatives with a positive carrying amount are detailed separately. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

## Notes to the Condensed Consolidated Financial Statements

44. Cont'd

<b>Derivative financial liabilities</b>	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Gross settled derivatives</b>							
Inflow .....	-	7,407	5,520	96,966	-	-	109,893
Outflow .....	-	(6,897)	(5,530)	(113,584)	-	-	(126,011)
Total	-	510	(10)	(16,618)	-	-	(16,118)
Net settled derivatives .....	-	(77)	-	-	-	-	(77)
<b>Total</b>	-	433	(10)	(16,618)	-	-	(16,195)

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

<b>Financial assets</b>	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank .....	19,827	67,232	-	-	-	-	87,059
Bonds and debt instruments .....	1,876	15,515	-	-	31,082	3,654	52,127
Shares and equity instruments .....	-	-	335	42	-	9,501	9,878
Loans to credit institutions .....	41,902	18,928	108	-	4	-	60,942
Loans to customers .....	74	56,194	46,578	144,163	299,896	-	546,905
Other financial assets .....	4,529	583	306	6,238	-	2,167	13,823
<b>Total financial assets</b>	68,208	158,452	47,327	150,443	330,982	15,322	770,734

### Derivative financial assets

<b>Gross settled derivatives</b>	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Inflow .....	-	5,605	518	8,815	-	-	14,938
Outflow .....	-	(5,415)	(430)	(9,095)	-	-	(14,940)
Total	-	190	88	(280)	-	-	(2)
Net settled derivatives	-	65	-	-	-	-	65
<b>Total</b>	-	255	88	(280)	-	-	63

The tables below show the comparative amounts for financial assets and liabilities at the end of 2011.

### Maturity analysis 31 December 2011

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

## Notes to the Condensed Consolidated Financial Statements

44. Cont'd

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Off balance sheet liabilities</b>							
Financial guarantees .....	6,893	-	-	-	-	-	6,893
Undrawn loan commitments .....	12,592	-	-	-	-	-	12,592
Undrawn overdrafts .....	21,449	-	-	-	-	-	21,449
Credit card commitments .....	22,202	-	-	-	-	-	22,202
<b>Total</b>	<b>63,136</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>63,136</b>

Total non-derivative financial liabilities and off balance sheet liabilities .....	496,272	81,651	40,570	75,528	78,968	2,293	775,282
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	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Derivative financial liabilities</b>							
<b>Gross settled derivatives</b>							
Inflow .....	-	6,258	2,498	78,562	25,000	-	112,318
Outflow .....	-	(6,131)	(2,979)	(94,688)	(25,074)	-	(128,872)
Total	-	127	(481)	(16,126)	(74)	-	(16,554)
Net settled derivatives	-	(38)	-	-	-	-	(38)
<b>Total</b>	<b>-</b>	<b>89</b>	<b>(481)</b>	<b>(16,126)</b>	<b>(74)</b>	<b>-</b>	<b>(16,592)</b>

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Financial assets</b>							
Cash and balances with Central bank .....	22,937	35,055	-	-	-	-	57,992
Bonds and debt instruments .....	6,617	16,494	82	152	31,361	3,956	58,662
Shares and equity instruments .....	-	-	525	48	-	10,534	11,107
Loans to credit institutions .....	22,027	21,556	-	-	72	-	43,655
Loans to customers .....	-	50,523	46,877	169,833	297,161	-	564,394
Other financial assets .....	-	2,567	237	2	-	380	3,186
<b>Total financial assets</b>	<b>51,581</b>	<b>126,195</b>	<b>47,721</b>	<b>170,035</b>	<b>328,594</b>	<b>14,870</b>	<b>738,996</b>

	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
<b>Derivative financial assets</b>							
<b>Gross settled derivatives</b>							
Inflow .....	-	8,069	773	33,058	-	-	41,900
Outflow .....	-	(7,976)	(692)	(32,860)	-	-	(41,528)
Total	-	93	81	198	-	-	372
Net settled derivatives	-	21	-	-	-	-	21
<b>Total</b>	<b>-</b>	<b>114</b>	<b>81</b>	<b>198</b>	<b>-</b>	<b>-</b>	<b>393</b>

As a part of managing liquidity risk, the Bank holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Bank's liquidity back-up at the end of 2011 and end of Q3 2012. The liquidity facility line with the Government expired at end of September and is therefore no longer included in the Bank's liquid assets at end of Q3 2012.

<b>Composition and amount of liquidity back-up</b>	30.9.2012	31.12.2011
Cash and balances with Central Bank .....	87,059	57,992
Domestic bonds eligible as collateral against borrowing at the Central Bank .....	15,177	55,024
Foreign government bonds .....	15,516	16,323
Short-term placements with credit institutions .....	55,485	36,695
Government liquidity facility .....	-	25,000
<b>Composition and amount of liquidity back-up</b>	<b>173,237</b>	<b>191,034</b>

# Notes to the Condensed Consolidated Financial Statements

## Market risk

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

### Market risk management

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

The Bank separates exposures to market risk into trading book and banking book (non-trading portfolios). The Bank's primary sources of market risk in the trading portfolio are shares, debt instruments and foreign currency positions. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. Market risk in the banking book is mainly originated from mismatches in assets and liabilities with respect to currencies, interest reset dates and inflation indexation and from shares and equity instruments acquired through restructuring. These mismatches are reported to management and are subject to regulatory and internal limits.

## Interest rate risk

46. Interest rate risk in trading portfolios

The fixed income trading unit invests mainly in government bonds and bonds issued by the Housing Financing Fund (HFF), which are guaranteed by the Icelandic government. These positions can include short positions. The Bank holds a significant amount of highly liquid foreign government bills in its liquidity portfolio. The bills are held for cash management purposes and can be liquidated with a short notice.

Trading bonds and debt instruments, long positions	30.9.2012			31.12.2011		
	MV	Duration	BPV	MV	Duration	BPV
Indexed .....	312	9.11	(0.28)	379	9.22	(0.35)
Non-indexed .....	16,450	0.46	(0.76)	17,231	0.32	(0.55)
<b>Total</b>	<b>16,762</b>	<b>0.62</b>	<b>(1.04)</b>	<b>17,610</b>	<b>0.51</b>	<b>(0.90)</b>

  

Trading bonds and debt instruments, short positions	30.9.2012			31.12.2011		
	MV	Duration	BPV	MV	Duration	BPV
Indexed .....	591	7.77	0.46	962	7.89	0.76
Non-indexed .....	46	9.35	0.04	364	8.17	0.30
<b>Total</b>	<b>637</b>	<b>7.88</b>	<b>0.50</b>	<b>1,326</b>	<b>7.97</b>	<b>1.06</b>

  

Net position of trading bonds and debt instruments	16,125	0.34	(0.54)	16,284	(0.09)	0.16
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## Notes to the Condensed Consolidated Financial Statements

### 47. Interest rate risk in the banking book

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

Banking book interest rate adjustment periods on 30 September 2012

	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
<b>Assets</b>							
Cash and balances with Central Bank .....	84,902	-	-	-	-	-	84,902
Bonds and debt instruments .....	32,347	1,959	430	456	571	60	35,823
Loans to credit institutions .....	60,834	108	-	-	-	-	60,942
Loans to customers .....	388,782	35,228	32,703	74,084	1,328	14,780	546,905
<b>Total assets</b>	<b>566,865</b>	<b>37,295</b>	<b>33,133</b>	<b>74,540</b>	<b>1,899</b>	<b>14,840</b>	<b>728,572</b>
Off balance sheet items.....	56,910	7,301	10,901	1,505	113	-	76,730
<b>Liabilities</b>							
Short positions .....	-	3,208	1,314	880	-	-	5,402
Deposits from Central Bank .....	13	-	-	-	-	-	13
Deposits from credit institutions .....	36,338	5,570	-	-	-	-	41,908
Deposits from customers .....	476,098	1,559	1,563	1,573	1,751	-	482,544
Debt issued and other borrowed funds .....	8,802	-	-	4,683	48,374	2,634	64,493
Subordinated loans .....	22,093	-	-	-	-	-	22,093
<b>Total liabilities</b>	<b>543,344</b>	<b>10,337</b>	<b>2,877</b>	<b>7,136</b>	<b>50,125</b>	<b>2,634</b>	<b>616,453</b>
Off balance sheet items .....	60,614	7,463	11,108	1,538	-	-	80,723
<b>Net interest gap on 30 September 2012</b>	<b>19,817</b>	<b>26,796</b>	<b>30,049</b>	<b>67,371</b>	<b>( 48,113)</b>	<b>12,206</b>	<b>108,126</b>

Banking book interest rate adjustment periods 31 December 2011

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

## Notes to the Condensed Consolidated Financial Statements

### Currency risk

48. Currency risk is the risk that earnings or capital may be negatively affected by the fluctuations of foreign exchange rates, due to transactions in foreign currencies or due to a mismatch in the currency composition of assets and liabilities.

#### Currency analysis 30 September 2012

<b>Assets</b>	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank.....	395	161	67	31	21	255	930
Bonds and debt instruments.....	6,791	8,421	73	1	-	1,079	16,365
Shares and equity instruments.....	454	228	22	-	-	-	704
Loans to credit institutions.....	23,479	19,515	3,303	677	2,363	6,974	56,311
Loans to customers.....	60,338	15,847	4,116	15,912	17,395	2,491	116,099
Investments in associates.....	20	551	-	-	-	367	938
Other assets.....	159	1,409	126	-	2	37	1,733
<b>Total assets</b>	<b>91,636</b>	<b>46,132</b>	<b>7,707</b>	<b>16,621</b>	<b>19,781</b>	<b>11,203</b>	<b>193,080</b>
<b>Liabilities</b>							
Deposits from credit institutions .....	163	152	-	-	-	-	315
Deposits from customers .....	31,239	25,861	4,883	753	837	5,472	69,045
Debt issued and other borrowed funds .....	-	-	-	-	-	78	78
Subordinated loans .....	22,093	-	-	-	-	-	22,093
Other liabilities.....	1,166	3,293	608	1	15	221	5,304
<b>Total liabilities</b>	<b>54,661</b>	<b>29,306</b>	<b>5,491</b>	<b>754</b>	<b>852</b>	<b>5,771</b>	<b>96,835</b>
Non-adjusted foreign exchange							
on balance sheet imbalance .....	36,975	16,826	2,216	15,867	18,929	5,432	96,245
Adjustment of currency							
imbalance for FX/ISK loans .....	7,317	981	143	7,301	6,983	228	22,953
<b>Adjusted imbalance</b>	<b>29,658</b>	<b>15,845</b>	<b>2,073</b>	<b>8,566</b>	<b>11,946</b>	<b>5,204</b>	<b>73,292</b>
<b>Off balance sheet items</b>							
Off balance sheet assets .....	2,312	12,426	-	40	1,802	1,379	17,959
Off balance sheet liabilities .....	19,133	24,344	641	8,993	14,113	1,403	68,627
<b>Net off balance sheet items</b>	<b>( 16,821)</b>	<b>( 11,918)</b>	<b>( 641)</b>	<b>( 8,953)</b>	<b>( 12,311)</b>	<b>( 24)</b>	<b>( 50,668)</b>
Net currency imbalance							
on 30 September 2012.....	12,837	3,927	1,432	( 387)	( 365)	5,180	22,624

## Notes to the Condensed Consolidated Financial Statements

48. Cont'd

### Currency analysis 31 December 2011

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

## Derivatives

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

## Inflation risk

50. The Bank is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 30 September 2012 the CPI gap amounted to ISK 17.0 billion (31 December 2011: ISK 22.2 billion). Thus, a 1% increase in the index would have a positive impact on the profit and loss account to the amount of ISK 170 million in profit and a 1% decrease would result in a corresponding loss, other risk factors held constant.



# Notes to the Condensed Consolidated Financial Statements

## Capital management

51. Under Icelandic law the minimum capital requirement is 8.0% of risk weighted assets in accordance to the EU capital requirements directives (CRD).

As part of the conditions for granting the Bank an operating license as a financial undertaking, the Icelandic Financial Supervisory Authority (FME) required the Bank to maintain a minimum Core Tier 1 ratio of 12% of risk weighted assets and a total capital ratio, allowing for subordinated Tier 2 debt, of 16% for the first three years of operations.

Capital requirements in excess of the legal minimum of 8% of risk weighted assets are now discretionary based on the outcome of the results from the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP) conducted by the FME.

Current capital ratios are well in excess of both internal and regulatory requirements.

The Bank's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach. Market risk exposure for currency risk is based on the adjusted currency imbalance described in note 48.

The table below shows the capital base, risk weighted assets and capital ratios of the Bank at 30 September 2012 and 31 December 2011. In addition, the table shows the official capital ratios based on reviewed retained earnings at 30 June 2012.

	30.9.2012	31.12.2011
<b>Tier 1 capital</b>		
Ordinary share capital .....	10,000	10,000
Share premium .....	55,000	55,000
Other reserves .....	2,731	2,661
Retained earnings .....	71,235	55,133
Non-controlling interests .....	1,079	909
Tax assets .....	( 1,533)	( 2,629)
Intangible assets .....	( 602)	( 544)
Other regulatory adjustments .....	( 436)	-
<b>Total Tier 1 capital</b>	<b>137,474</b>	<b>120,530</b>
<b>Tier 2 capital</b>		
Other regulatory adjustments .....	( 436)	-
Qualifying subordinated liabilities .....	22,093	21,937
<b>Total capital base</b>	<b>159,131</b>	<b>142,467</b>
<b>Risk weighted assets</b>		
- due to credit risk .....	550,724	532,301
- due to market risk: .....	25,060	16,695
Market risk, trading book .....	1,685	1,895
Currency risk foreign exchange .....	23,375	14,800
- due to operational risk .....	80,423	80,423
<b>Total risk weighted assets</b>	<b>656,207</b>	<b>629,419</b>
<b>Capital ratios</b>		
Tier 1 ratio .....	20.9%	19.1%
Total capital ratio .....	24.3%	22.6%
Official Tier 1 ratio.....	20.2%	19.1%
Official capital ratio.....	23.5%	22.6%