

Íslandsbanki

Consolidated Financial Statements 2009

Íslandsbanki · Kirkjusandur · 155 Reykjavík · Reg.no. 491008-0160



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Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Íslandsbanki hf. for the period ended 31 December 2009 comprise the Financial Statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Bank".

Foundation and ownership

The Bank was incorporated on 8 October 2008 and on 15 October 2008 it acquired assets and liabilities relating to the domestic operations of Giltinir Banki hf. ("Giltinir") which had been taken into public ownership following the passing of an Emergency Act in October 2008.

For the large part of 2009 the ownership of the Bank was in the hands of the Icelandic government. On 15 October 2009 the Resolution Committee of Giltinir decided to exercise an option to acquire 95% of the share capital of the Bank as of 11 September 2009.

This agreement on change in ownership was subject to ratification by the Financial Supervisory Authority (FME) which placed restrictions on the terms of the agreement relating to ownership, financial strength, strategic decision making and reporting requirements. As part of the agreement, the government provided the Bank with a subordinated Tier II loan of EUR 138 million in equity and liquidity support.

The transfer of ownership was finalised on 31 December 2009. The Icelandic government retains a 5% stake in the Bank.

The first Board of Directors of Íslandsbanki acted from incorporation to 7 November 2008. The second Board of Directors acted until the Annual General Meeting of the Bank on 25 January 2010 when the current Board members were elected. Six of the Board members were appointed by ISB Holding ehf., a subsidiary of GLB Holding ehf. which is a holding company owned by Giltinir. One Board member was appointed by the Icelandic State Banking Agency (Bankasýsla ríkisins) which manages the 5% share capital retained by the government.

Operations

The Bank is divided into six business segments: Retail Banking, Corporate & Investment Banking, Asset Management, Treasury, Capital Markets and Midengi (a restructuring company).

Since its establishment, the Bank has focused on strengthening its foundations by reinforcing its infrastructure and reviewing policies and processes with a view to adopting best practice methods.

At balance sheet date there were 1034 full-time employees of the Bank.

Outlook

The economic environment in Iceland during 2009 was fragile and is likely to continue to be so for some time to come. Many borrowers are likely to continue to face financial difficulties.

One of the Bank's main focuses in 2009 was formulating the restructuring of the acquired loan assets in order to maximise recovery and monitor the risks of valuation. This restructuring will continue in 2010 along with the implementation of further measures designed to reinforce the Bank's infrastructure.

The Bank's Board and Management will continue to place emphasis on the challenges raised by the volatility of the local currency and customer retention as well as reviewing its operations and processes to enhance objectivity, transparency and disciplined processes. By improving the proficiency of its lending and risk management systems, the Bank will ensure that it continues to be well positioned to serve the customers and sustain profitability.

The Bank will continue building its client base from the existing network and nurturing existing business relationships for future growth and profitability. It aims to continue its leadership in providing new products to individuals and businesses to suit their needs.

The Bank's comprehensive knowledge of two industries, fisheries and geothermal energy, contributes to its strategic strength. Through these key industries the Bank maintains an international reach that serves to support its future development.

Endorsement and Statement by the Board of Directors and the CEO

Accounting convention

The consolidated financial statements for the year ended 31 December 2009 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

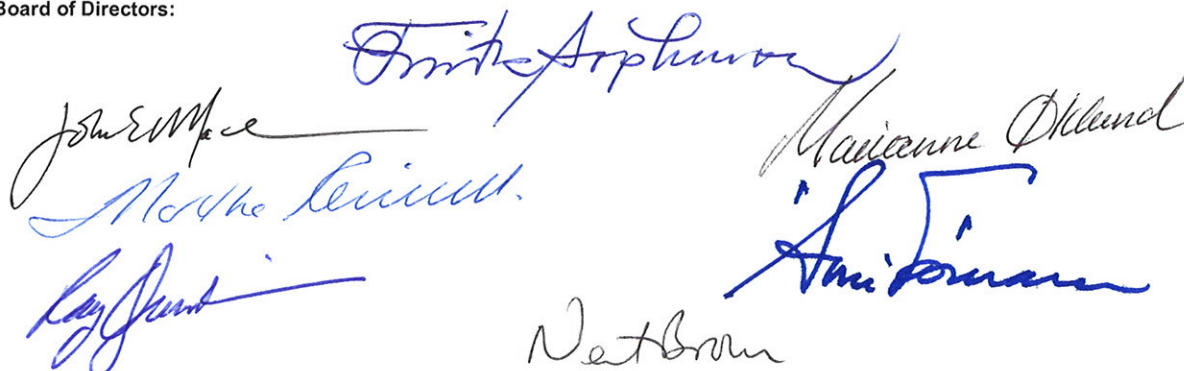
The profit from the Bank's operations for the year ended 31 December 2009 amounted to ISK 23,982 million, which corresponds to a 30.0% return on equity. The Board of Directors proposes to pay no dividend for the year 2009. Bank equity, according to the consolidated balance sheet, amounted to ISK 92,103 million at year end. The Bank's capital adequacy ratio, calculated according to the Act on Financial Undertakings, was 19.8%. Under Icelandic law the minimum requirement is 8.0%. However, as part of granting the Bank an operating licence as a financial undertaking, the Icelandic Financial Supervisory Authority (FME) requires the Bank to maintain a minimum Core Tier 1 ratio of 12% of risk weighted assets and a solvency ratio, allowing for subordinated Tier 2 debt, of 16%. The Bank's total assets amounted to ISK 717,342 million at year end.

To the best of our knowledge, the consolidated financial statements provide a true and fair view of the Bank's operating profits and its financial position at 31 December 2009. It also describes the principal risks and uncertainties currently faced by the Bank. These are discussed further in note 2.4.

The Board of Directors and the CEO of Íslandsbanki hf. hereby confirm the Bank's consolidated financial statements for the period 1 January to 31 December 2009 by means of their signatures.

Reykjavik, 23 March 2010

Board of Directors:

The Board of Directors section contains six handwritten signatures in blue ink. From top to bottom, they are: a signature that appears to be 'Ólafur Jóhannsson', a signature that appears to be 'John E. Mc...', a signature that appears to be 'Móttóla Leinuv.', a signature that appears to be 'Ragnfríður...', a signature that appears to be 'Máirí Óskarsdóttir', and a signature that appears to be 'Árnór Þórsson'. Below the signature 'Árnór Þórsson' is the printed name 'Netbrun'.

Chief Executive Officer:

The Chief Executive Officer section contains one handwritten signature in blue ink that appears to be 'Björn Þinarsdóttir'.

Independent Auditors' Report

To the Board of Directors and Shareholders of Íslandsbanki hf.

We have audited the accompanying Consolidated Financial Statements of Íslandsbanki hf. and its subsidiaries (the "Bank"), which comprise the Consolidated Statement of Financial Position as at 31 December 2009, and the Consolidated Statement of Comprehensive Income, Consolidated Statement of Changes in Equity, and Consolidated Statement of Cash Flow for the period then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these Consolidated Financial Statements in accordance with International Financial Reporting Standards as adopted by the EU. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the Consolidated Financial Statements give a true and fair view of the consolidated financial position of Íslandsbanki hf. as of 31 December 2009, and of its consolidated financial performance and its consolidated cash flows for the period then ended in accordance with International Financial Reporting Standards as adopted by the EU.

Kópavogur, 23 March 2010

Deloitte hf.



Pálína Árnadóttir
State Authorised Public Accountant



Páll Grétar Steingrímsson
State Authorised Public Accountant

Consolidated Statement of Comprehensive Income for the year 2009

	Notes	2009	15.10.-31.12. 2008
Interest income		86,913	27,719
Interest expense .....	(	54,929)	(17,117)
Net interest income	9	31,984	10,602
Fee and commission income		10,130	2,221
Fee and commission expense .....	(	3,069)	(580)
Net fee and commission income	10	7,061	1,641
Net financial income	11-14	11,137	37,570
Other net operating income	15	2,760	703
Income due to revised estimated future cash flows from loans	2.5	18,419	3,248
Net impairment losses on financial assets	33 (	26,326)	(47,002)
Operating income		45,036	6,760
Administrative expenses	16-20 (	16,113)	(4,085)
Net (loss) gain on non-current assets and disposal groups held for sale	21 (	263)	1
Share of profit of associates	35	0	54
Profit before income tax		28,660	2,730
Income tax	22,50 (	4,678)	(364)
Profit for the year		23,982	2,366
Other comprehensive income			
Foreign currency translation differences for foreign operations		2	4
Other comprehensive income for the period (net of tax)		2	4
Total comprehensive income for the period			
		23,984	2,370
Attributable to:			
Equity holders of Íslandsbanki hf.		23,901	2,356
Non-controlling interests		81	10
Profit for the year		23,982	2,366
Basic earnings per share	23	2.39	0.24
Diluted earnings per share	23	2.39	0.24

The notes on pages 10 to 70 are an integral part of these consolidated financial statements.

Consolidated Statement of Financial Position as at 31 December 2009

	Notes	31.12.2009	31.12.2008
Assets			
Cash and balances with Central Bank	24	38,743	20,842
Derivatives	26	0	569
Bonds and debt instruments	27	66,701	34,067
Shares and equity instruments	28	2,250	2,535
Loans to banks	29	87,416	28,320
Loans to customers	31	489,611	484,933
Investments in associates	34-35	827	651
Investment property	38	2,056	1,679
Property and equipment	39	1,771	1,675
Intangible assets	40	107	0
Deferred tax assets	49-51	84	5
Non-current assets and disposal groups held for sale	41	19,014	2,154
Share subscription		0	66,512
Other assets	42	8,761	14,062
Total Assets		717,342	658,003
Liabilities			
Financial liabilities	43	7,332	4,910
Derivatives	26	0	569
Deposits from Central Bank	44	28	53,153
Deposits from banks	44	139,064	103,400
Deposits from customers	45-46	339,659	336,695
Debt issued and other borrowed funds	47	69,190	67,315
Subordinated loans	48	24,843	0
Current tax liabilities	49-51	4,807	377
Deferred tax liabilities	49-51	354	172
Non-current liabilities and disposal groups held for sale	41	16,905	1,285
Other liabilities	52	23,057	22,097
Total Liabilities		625,239	589,973
Equity			
Share capital	53	10,000	10,000
Share premium	53	55,000	55,000
Other reserves	54	2,059	240
Retained earnings		24,204	2,120
Total equity attributable to the equity holders of Íslandsbanki hf.		91,263	67,360
Non-controlling interests		840	670
Total Equity		92,103	68,030
Total Liabilities and Equity		717,342	658,003

The notes on pages 10 to 70 are an integral part of these consolidated financial statements.

Consolidated Statement of Changes in Equity for the year 2009

	Attributable to equity holders of Íslandsbanki hf.					Non- controlling interests	Total equity
	Share capital	Share premium	Other reserves	Retained earnings	Total		
	Issued new shares	775					
Issued new shares 15.10.2009 see note 53	9,225	55,000			64,225		
Equity as at 15.10.2008	10,000	55,000	0	0	65,000	660	65,660
Translation differences for foreign operations			4		4		4
Contribution to statutory reserve			236	(236)	0		0
Net income recognised directly in equity	0	0	240	(236)	4		4
Profit for the year				2,356	2,356	10	2,366
Total recognised income and expense for the year			240	2,120	2,360	10	2,370
Equity as at 31.12.2008	10,000	55,000	240	2,120	67,360	670	68,030
Translation differences for foreign operations			2		2		2
Contribution to statutory reserve			1,817	(1,817)	0		0
Net income recognised directly in equity			1,819	(1,817)	2	0	2
Profit for the year				23,901	23,901	81	23,982
Total recognised income and expense for the year	0	0	1,819	22,084	23,903	81	23,984
Issued new shares					0	89	89
Equity as at 31.12.2009	10,000	55,000	2,059	24,204	91,262	840	92,103

The notes on pages 10 to 70 are an integral part of these consolidated financial statements.

Consolidated Statement of Cash Flows for the year 2009

15.10.-31.12.

	Notes	2009	2008
Cash flows from operating activities:			
Profit for the year		23,982	2,366
Adjustments to reconcile profit for the year to cash flow used in operating activities:			
Non-cash items included in profit for the year and other adjustments			
Depreciation of property and equipment		509	149
Interest on share subscription		0	(2,287)
Impairments of financial assets		26,326	47,002
Income due to revised estimated cash flows from loans .....	(	13,687)	0
Unrealised foreign currency gain and loss .....	(	11,201)	(39,216)
Other		0	(56)
Changes in operating assets and liabilities:			
Loans and receivables .....	(	13,460)	(16,955)
Trading assets .....	(	5,155)	(29,105)
Deposits .....	(	64,867)	(7,191)
Debt issued and other borrowed funds		64,006	6,343
Trading financial liabilities		2,422	4,910
Other operating assets and liabilities		9,177	97
Net cash flow from operating activities		18,052	(33,943)
Cash flows from investing activities:			
Proceeds from business combination at 15 October 2008		0	53,054
Investments in associates		9	(91)
Property and equipment	39	(712)	(51)
Net cash (used in) provided by from investing activities		(703)	52,912
Cash flows from financing activities:			
Issued new shares		89	0
Net cash (used in) provided by financing activities		89	0
Net increase in cash and cash equivalents		17,438	18,969
Effects of exchange rate changes on cash and cash equivalents		463	1,098
Cash and cash equivalents at incorporation on 8 October 2008		0	775
Cash and cash equivalents on 1 January 2009		20,842	0
Cash and cash equivalents at year end	24	38,743	20,842
Reconciliation of cash and cash equivalents:			
Cash in hand	24	1,842	1,906
Cash balances with Central Bank	24	36,901	18,936
		38,743	20,842

The Bank has prepared its Cash Flow Statement using the indirect method. The Statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year. Cash and cash equivalents consist of cash in hand and demand deposits with Central Banks.

Non-cash transactions

During 2009 the Bank entered into the following non-cash investing and financing activities which are not reflected in the statement of cash flow:

- The government sold 95% of its shareholding to ISB Holding a holding company owned by GLB Holding, a subsidiary of Glitnir. Consideration for the sale was in the form of an offset of government bonds held by the Bank against the Bank's debt to Glitnir of 66bn. The transaction had no cash effect on the Bank.
- The Icelandic government provided the Bank with a Tier II subordinated loan of EUR 138m in equity and liquidity support as part of the said share transfer agreement. The transaction had no cash effect on the Bank.
- The Bank assumed deposits from Straumur-Burdarás Investment Bank (Straumur) for 45bn and received a bond guaranteed on Straumur assets. The transaction had no cash effect on the Bank (see note 58).

Notes to the Consolidated Financial Statements

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Notes to the Consolidated Financial Statements

1. General information

Íslandsbanki hf. is a limited company incorporated and domiciled in Iceland. The address of its registered office is Kirkjusandur 2, 155 Reykjavík, Iceland.

The consolidated financial statements for the year ended 31 December 2009 comprise Íslandsbanki hf. (the parent) and its subsidiaries (together referred to as "the Bank").

The Bank provides a wide range of financial services such as retail banking, corporate banking, brokerage services, investment management and asset-based financing. The Bank operates mainly in the Icelandic market. The Bank was incorporated by the Icelandic Financial Supervisory Authorities (FME) on 8 October 2008 and commenced trading on 15 October 2008 when it acquired assets and liabilities relating to the domestic operations of Glitnir Banki hf. ("Glitnir").

On 15 October 2009 the Icelandic government, being a 100% shareholder of the Bank, reached an agreement with the creditors of Glitnir whereas they would exercise their option and acquire 95% of the share capital of the Bank as per 11 September 2009, as consideration for assets and liabilities acquired. The Icelandic government retains a 5% stake.

As part of this agreement the government provided the Bank with a Tier II subordinated loan of EUR 138m in liquidity and equity support, effective from 11 September 2009.

The shareholding was transferred to ISB Holding, a holding company owned by GLB Holding which is a holding company under the ownership of Glitnir. The agreement was subject to a ratification by the FME and this was obtained under strict conditions relating to ownership, financial strength, strategic decision making and reporting requirements which effectively reduce GLB Holding's control over the Bank's operations for the first three years. The conditions are as follows:

a) Ownership shall be in the hands of a separate subsidiary (ISB Holding), its Board consisting of three Board Members independent of Glitnir, large creditors of Glitnir and the Bank. All Board Members must be ratified by the FME and are subject to certain requirements relating to education and experience. The Resolution Committee of Glitnir can appoint one member on the board of ISB Holding.

b) The board members of ISB Holding will retain voting rights in the Bank and are responsible for appointing the management board. The Resolution Committee of Glitnir can appoint one representative to the Board of Íslandsbanki. Other Board Members, including the Chairman, must be independent. Glitnir shall respect the independence of ISB Holding and not involve itself in the operation of the Bank. ISB Holding shall report quarterly to FME on Glitnir's independence.

c) Certain strategic restraints are put on the owners as to related party transactions, dividend payments and sale of shares in the Bank for the next three years. Any intended changes in ownership of ISB Holding or the Bank must be reported to the FME, which will then evaluate the competence of the new owners.

d) An emergency fund shall be made available in case of financial difficulties at the Bank.

These are the first full year consolidated financial statements of Íslandsbanki hf. and cover the period from 1 January to 31 December 2009. Comparative information provided in these consolidated financial statements refers to the period 15 October 2008 to 31 December 2008.

The following comparative amounts have been changed due to adjustments or reclassifications between the years:

Note 2.5 – Income of 3bn presented under net interest income as additional recovery in the Consolidated Financial Statements 2008 is presented as a single line item in the Income Statement 2009 as Income due to revised estimated future cash flows from loans. The change is made in order to make the presentation of these material amounts clearer on the face of the Income Statement.

Note 32 – Impairment allowance of 4.5bn has been moved from Loans to individuals to Loans to corporate entities. The change is made due to corrections in relation to categorisation between individuals and corporate entities.

Note 45 and 46 – Money Market loans presented as Loans from banks under Debt issued and other borrowed funds have been reclassified as Time deposits under Deposits from customers since this better describes the nature of the financial instrument. The comparative amount in 2008 was 4.8bn.

The consolidated financial statements are presented in Icelandic krona (ISK), which is the functional currency of the Bank. The amounts are presented in ISK million, unless otherwise mentioned.

The consolidated financial statements were approved and authorised for issue by the Board of Directors of Íslandsbanki hf. on 23 March 2010.

Notes to the Consolidated Financial Statements

2. Basis of preparation

2.1 Statement of compliance

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union.

Information about IFRS and amendments to IFRS issued but not effective for the period ended 31 December 2009 is disclosed in note 3.28.

2.2 Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, derivative financial instruments, loans to customers designated at fair value through profit or loss, debt issued and designated at fair value through profit or loss and investment property.

Non-current assets and disposal groups held for sale are measured at the lower of carrying amount and fair value less costs to sell.

2.3 Significant accounting judgements and estimates

The preparation of the consolidated financial statements in conformity with IFRS as adopted by the EU, 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 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.

The most significant accounting areas of estimation uncertainty and critical judgements in applying accounting policies relate to the following:

a) *Going concern*

Since the start of its operations on 15 October 2008, the Bank has taken significant steps towards aligning the organisation and operations to reflect its commercial strategy. The main emphasis has been on strengthening the risk and control environment and redefining processes and policies with a view to adopting best practice methods and improving risk awareness.

The Bank has strengthened its debt management functions and works closely with customers who are experiencing payment difficulties in order to ensure maximum recovery of its assets.

Uncertainties in relation to the valuation and recoverability of the acquired portfolio are discussed in detail in note 2.4. The full extent of the repercussions that are likely to be experienced in wake of the recession which Iceland is currently undergoing are difficult to ascertain. The Bank continues to monitor its loan portfolio closely in the context of developments within the Icelandic economy as well as in markets abroad.

The Bank is subject to currency risk due to a mismatch in the contractual currencies in the assets and liabilities of the Bank. As discussed in note 70 this imbalance is offset to some extent by loans with non-ISK contractual currency to borrowers with ISK-based income. These loans are effectively treated as ISK assets whereby the Bank impairs against related increases in loan balances due to depreciation of the ISK. With this adjustment the Bank's net currency imbalance at 39bn is more manageable. The Bank seeks to manage the currency imbalance through its operations and balance sheet management. For example, borrowers with ISK income have been offered the option to convert their non-ISK loans into ISK-based loans at a discount.

Notes to the Consolidated Financial Statements

2.3 Cont'd

Currently, most of the Bank's funding is from on-demand deposits. The Bank is confident that this will change over the coming years as investors' risk aversion reduces and they start seeking higher yielding investment opportunities. In the future, the Bank will focus on extending the maturities of its deposit base and at the same time start to issue short term unsecured notes and, to some extent, longer term secured bonds. Access to funding in foreign currencies will be limited in the short to medium term, although international markets are improving rapidly.

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 the resources to continue in business for the foreseeable future. Therefore, the financial statements continue to be prepared on a going concern basis.

b) *Determination of fair value*

The Bank determines the fair value of financial assets and financial liabilities that are not quoted in active markets by using valuation techniques as described in accounting policy 3.6. To the extent that it is practical, models use only observable data. However, for financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risks affecting the specific instrument, such as credit risk (both own and counterparty).

The Bank determined the fair value of assets and liabilities acquired from Glitnir Banki hf. on 15 October 2008. Assumptions and uncertainties in relation to the acquired portfolio are described in note 2.4.

c) *Impairment allowances for loans and receivables*

The Bank recognises allowances for impairment for loans and receivables. For this purpose the Bank's management reviews its loan portfolios on a quarterly basis to assess whether there is any objective evidence of impairment. In determining whether an impairment allowance should be recognised in the income statement, the Bank's management makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from loans and receivables. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group.

When scheduling its future cash flows the Bank's management uses estimates based on loans and receivables with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Impairment allowance for loans and receivables is disclosed in more detail in note 3.23.

d) *The application of the effective interest method*

The application of the effective interest method when calculating the amortised cost of financial assets and financial liabilities requires management to estimate future cash payments or receipts through the expected life of the financial instrument, considering all contractual terms of the financial instrument (for example, prepayment, call and similar options). Revisions to estimates of future cash flows, other than those arising from changes in market variables, generally result in the Bank having to adjust the carrying amount of the financial asset or financial liability to reflect actual and revised estimated cash flows. In such cases the adjustment is recognised as income or expense in profit or loss in the period in which the estimate is revised.

e) *Liquidity*

The Bank manages its liquidity by maintaining an adequate portfolio of liquid assets against liabilities. Internal liquidity limits assume that liquid assets cover all liabilities expected to mature within the next 12- month period, even under stressed market conditions.

Since a large part of the Bank's liabilities is in the form of demand deposits, the expected maturity profile is based on analysis of the historical behaviour and other characteristics of the deposit base.

The contractual maturity profile is set out in the liquidity risk disclosure in note 67. The table requires judgement with respect to whether assets can be considered liquid and when deposits will be withdrawn.

Notes to the Consolidated Financial Statements

2.4 Assumptions and uncertainties in relation to the acquired portfolio

There are great uncertainties in most of the input parameters and assumptions used in the valuation process of the assets acquired at a deep discount. The Bank's management has, however, striven to reach the best appropriate value estimates based on known facts, their knowledge of the customers and the market and on official macroeconomic forecasts from the Central Bank of Iceland, the IMF and the OECD.

Factors that can affect the recovery value of the loan portfolio include macroeconomic parameters such as the unemployment rate, inflation and wage growth, actions taken by the government to facilitate and ease debt service and possible new legislation that lengthens the collection process or increases taxation and the extent of customer participation in flexible maturity and payment equalisation programmes.

Since the valuation is based on expected five-year cumulative losses with conservative estimates for collateral values and a prudent risk premium, the Bank's management is confident that the valuation of the acquired portfolio is robust enough to absorb the effects of realistic perturbations in applied assumptions.

At year end 31 December 2009 the economic environment and uncertainties surrounding the valuation of the financial assets acquired at deep discount remain largely unchanged.

2.5 Financial effects of assets acquired at deep discount

Deep discount

A loan is defined as having been acquired at a deep discount when the fair value purchase price is considerably lower than the balance according to the terms of the loan. The difference is explained by severe financial difficulties of the debtor which manifests itself in a higher credit spread when estimating the fair value of the loans and not because of changes in business environment since the terms of the loan were agreed i.e. market interest and liquidity.

A large proportion of the Bank's current financial assets were acquired at a deep discount. Credit losses already incurred were reflected in the purchase price and included in the estimated future cash flows when computing the effective interest rate.

The Bank's loan systems calculate interest, indexation and foreign exchange gains/losses on the gross loan amount in accordance with the terms of the loan. The Bank then applies the effective interest method to adjust the net book value in line with the estimated future cash flows.

Revised estimated future cash flows

Any revisions to estimated future cash flows subsequent to initial recognition, e.g. recovery of previously incurred credit losses, are recognised as part of the carrying amount of the financial asset with a corresponding amount recognised in profit or loss. Revisions to the estimated future cash flows are recognised immediately in profit or loss in the accounting period when the change in estimate was made.

Upwards changes in revised estimated future cash flows are recognised under the impairment line to the extent that is a reversal of impairment losses incurred after acquisition. The remaining balance is recognised as a single line item in the Income Statement (see Income from revised estimated future cash flows from loans in the Income Statement).

Downwards revisions to estimated cash flows are recognised as impairment.

At 31 December 2009 the Bank carried out a revaluation on loans to large corporate borrowers. The revaluation was based on the same assumptions as used in the initial valuation of the acquired portfolio. Subsequent changes in estimated future cash flows related to changes in present value of collaterals.

Impairment of foreign exchange gains

ISK 158bn of the acquired loan book are loans in foreign currencies to borrowers with ISK revenue and cash flow. The foreign exchange gain or loss on these loans is realised as net financial income. The Bank does not expect to recover foreign exchange gains relating to these loans and the foreign exchange gain is therefore fully impaired.

Notes to the Consolidated Financial Statements

2.5 Cont'd

If there are major sources of estimation uncertainties in relation to impairment that present a significant risk of material adjustment to the carrying amounts of the loans and receivables within the next financial year, assumptions made are disclosed in the financial statements.

In the valuation process for the assets acquired at deep discount, loans to customers were categorised as 1) Large Corporates, 2) Small Medium Enterprises (SMEs) and 3) Individuals. Large Corporates comprises the Bank's 250 largest borrowers each reviewed on an independent case-by-case basis. Other corporate borrowers were classified as SMEs and non-corporate borrowers as Individuals.

Critical assumptions used in the valuation are as follows:

Large Corporates

Specific valuation was performed for loans to the Bank's largest borrowers. These include approximately 250 companies with nominal value of about 50% of all loans to customers. The companies were divided into the following classes: (a) non-financial companies where the Bank holds a charge on fixed assets, (b) non-financial companies where the Bank does not have a charge on fixed assets, (c) fisheries companies, (d) holding companies, (e) financial enterprises and (f) companies with financing or leasing contracts.

Credit managers for these companies provided key information for each of them which was used in calculating the fair value. This information included (a) normalised EBITDA based on forward-looking view of economic developments, (b) information on collateral, specifically where the Bank holds a charge on fixed assets including information on the size of the property, its location and the priority of the lien act, (c) information on charges on vessels and their catch quotas as well as valuation estimates if available, (d) debt owed to other credit institutions and (e) information on the assets of holding companies.

The valuation was standardised by using a common valuation method for real estate, the automobile market and the fisheries industry. It was assumed that repossessed real estate would be divested in four years' time which is in line with predicted market development. The catch quota was valued by considering the return of the Icelandic fishing industry as a whole.

The EV/EBITDA multiples method was used for going concern companies. The net present value ("NPV") of collateral recovery was used as the fair value estimate for companies that do not generate positive cash flow and for companies where the value of collateral was higher than the enterprise value.

SMEs and Individuals

The loan portfolios comprising SMEs and individuals were stratified into homogeneous pools of exposures by specific criteria in such a way that the loans in each pool had approximately the same values for the main risk drivers. The fair value of each pool was then calculated as the NPV of the expected credit adjusted cash flows. It was assumed that within five years' time, all loans would either have been restructured or renegotiated on sustainable terms. It was therefore deemed sufficient to estimate the cash flows generated by each loan portfolio for the next five years. For loans with maturities longer than five years, the future values were assumed to equal the face value at the end of the five-year restructuring period.

An important part of the valuation is the forecast of yearly expected losses for each pool which directly affects the credit adjusted cash flow. The development of the loss rate for the next five years compared to a long-term average was estimated using a regression model on a 15-year history of annual portfolio losses using macroeconomic variables as predictors. The long-term average loss was in turn estimated using the Bank's internal risk models for probability of default and loss given default. This average loss rate depends on the credit rating of customers, the value of underlying collateral and other factors.

The discount rate used has three components: the zero coupon risk free rate, the Bank's funding cost and a risk premium. The risk premium is added to cover unexpected losses, cost of binding regulatory required capital and a general uncertainty in the valuation. Cash flows from foreign currency denominated loans to Icelandic individuals and companies with only ISK revenue were discounted using ISK interest rates. This is due to the fact that underlying expected cash flows do not grow with the devaluation of the ISK.

Notes to the Consolidated Financial Statements

2.5 Cont'd

Mortgages and leasing

The bank expects a dramatic increase in applications for postponement of payments for mortgages and leasing, as well as overdraft limits and extension of bullet loans. It was assumed that repossessed real estate would be divested in four years' time, which is in line with predicted market development.

Bonds and debt instruments

The bond market was extremely volatile following Glitnir's collapse. Fear and uncertainty surrounding bank deposits caused a run on all government bonds and government-backed bond yields fell by hundreds of basis points. This large increase in demand eventually led to such a shortage of bonds that market makers could no longer renew their offers at the market and subsequently the Central Bank announced that market makers were temporarily released from their obligation to quote bid and ask in the RIKB treasury bonds. The market has since stabilised.

As there was no active market for housing bonds (IBH) and the indexed treasury bonds (RIKS), their price was estimated in line with the price of Housing Financing Fund (HFF) and treasury bonds (RIKB), taking into consideration duration and low liquidity, issued by the same issuers. The HFF is an independent government institution granting mortgage loans to individuals, municipalities, companies and organisations to finance housing.

Shares and equity instruments

Following the collapse of the Icelandic stock market in October 2008 stock liquidity decreased drastically. Most Icelandic companies are highly leveraged with large short-term financing needs and debt-to-equity transactions with major stock dilution are highly likely. Interest rates are high and thus the risk-free rate for Icelandic companies, business and stock price is extremely depressive. The uncertainty and difficult market conditions were taken into account when valuing shares and equity instruments acquired.

Notes to the Consolidated Financial Statements

3. Significant accounting policies

3.1 The accounting policies set out below have been applied consistently by the Bank's entities.

Basis of consolidation

a) Subsidiaries

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiaries. In assessing control, potential voting rights that are currently exercisable or convertible, if any, are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. The financial statements have been prepared using uniform accounting policies for like transactions and other events in similar circumstances.

The purchase method of accounting is used to account for the acquisition of subsidiaries and other businesses by the Bank. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed, and equity instruments issued, plus cost directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair value at the acquisition date, irrespective of the extent of any minority interest, except for non-current assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, which are recognised at fair value less costs to sell. The excess of the cost of acquisition over the fair value of the Bank's share of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised immediately as income in the income statement.

b) Non-controlling interests

Non-controlling interests represent the portion of profit or loss and net assets not owned, directly or indirectly, by the Bank and are presented separately in the income statement and within equity in the consolidated balance sheet, separately from the equity attributable to equity holders of Íslandsbanki hf. Disposals to non-controlling interests result in gains and losses for the Bank that is recorded in the income statement.

c) Special purpose entities

Special purpose entities are entities that are created to accomplish a narrow and well-defined objective such as the securitisation of particular assets, or the execution of a specific borrowing or lending transaction. The Financial Statements of special purpose entities are included in the Bank's Consolidated Financial Statements where the substance of the relationship is that the Bank controls the special purpose entity.

d) Associates

Associates are those entities over which the Bank has significant influence, which is the power to participate in the financial and operating policy decisions of the associates but is not control or joint control over those policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights, if any.

Investments in associates are accounted for using the equity method and are initially recognised at cost. The investments include goodwill identified on acquisition, net of any accumulated impairment losses. The carrying amount of the investments is adjusted for post-acquisition changes in the Bank's share of net assets of the associates and for impairment losses, if any. Therefore, the consolidated financial statements include the Bank's share of the total recognised gains and losses of associates, from the date that significant influence commences until the date that significant influence ceases. When the Bank's share of losses exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Bank resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

Notes to the Consolidated Financial Statements

3.1 Cont'd

e) *Funds management*

The Bank manages and administers assets held in unit trusts and other investment vehicles on behalf of investors. The financial statements of these entities are not included in these consolidated financial statements except when the Bank controls the entity.

f) *Transactions eliminated on consolidation*

Intragroup balances, and any unrealised gains and losses or income and expenses arising from intrabank transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates and jointly controlled entities are eliminated to the extent of the Bank's interest in them. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

3.2 Business combinations

Acquisitions of subsidiaries and businesses are accounted for using the acquisition method. The consideration for each acquisition is measured as the aggregate of the fair values (at the date of exchange) of assets given, liabilities incurred or assumed, and equity instruments issued by the Group in exchange for control of the acquiree. Acquisition-related costs are recognised in profit or loss as incurred.

Where applicable, the consideration for the acquisition includes any asset or liability resulting from a contingent consideration arrangement, measured at its acquisition-date fair value. Subsequent changes in such fair values are adjusted against the cost of acquisition where they qualify as measurement period adjustments. All other subsequent changes in the fair value of contingent consideration classified as an asset or liability are accounted for in accordance with relevant IFRSs. Changes in the fair value of contingent consideration classified as equity are not recognised.

Where a business combination is achieved in stages, the Group's previously held interests in the acquired entity are revalued to fair value at the acquisition date (i.e. the date the Group attains control) and the resulting gain or loss, if any, is recognised in profit or loss. Amounts arising from interests in the acquiree prior to the acquisition date that have previously been recognised in other comprehensive income are reclassified to profit or loss, where such treatment would be appropriate if that interest were disposed of.

The acquiree's identifiable assets, liabilities and contingent liabilities that meet the conditions for recognition under IFRS 3 are recognised at their fair value at the acquisition date, except that:

- deferred tax assets or liabilities and liabilities or assets related to employee benefit arrangements are recognised and measured in accordance with IAS 12 Income Taxes and IAS 19 Employee Benefits respectively;
- liabilities or equity instruments related to the replacement by the Group of an acquiree's share-based payment awards are measured in accordance with IFRS 2 Share-based Payment;
- assets (or disposal groups) that are classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations are measured in accordance with that standard.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Bank reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period, or additional assets or liabilities are recognised, to reflect new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the amounts recognised as of that date.

The measurement period is the period from the date of acquisition to the date the Bank obtains complete information about facts and circumstances that existed as of the acquisition date – and is subject to a maximum of one year.

Notes to the Consolidated Financial Statements

3.3 Foreign currencies

a) *Foreign currency transactions*

Items included in the financial statements of each of the Bank's entities are measured using the functional currency of the respective entity. Transactions in foreign currencies are translated into functional currencies at the foreign exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are retranslated into functional currencies at the foreign exchange rate prevailing at that date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are retranslated into the functional currency at the spot exchange rate at the date that the fair value was determined. Foreign currency differences arising on retranslation are recognised in profit or loss.

b) *Foreign operations*

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on consolidation, are translated to the presentation currency, Icelandic krona (ISK), at foreign exchange rates prevailing at the balance sheet date. The revenues and expenses of foreign operations are translated to Icelandic krona at rates approximating the foreign exchange rates ruling at the dates of the transactions. Foreign exchange differences arising on translation are recognised directly in the translation reserve in equity. When a foreign operation is disposed of, in part or in full, the relevant amount in the translation reserve is transferred from equity and recognised in the income statement as part of the gain or loss on sale.

3.4 Financial assets

For the purpose of measurement, the Bank classifies its financial assets in the following categories: financial assets held for trading, financial assets designated at fair value through profit or loss, loans and receivables, and available-for-sale financial assets. Management determines the classification of financial assets at initial recognition.

a) *Financial assets held for trading*

Financial assets held for trading are financial assets acquired principally for the purpose of selling or repurchasing in the near term, or for holding as part of a portfolio that is managed together for short-term profit or position taking. Financial assets held for trading consist of bonds and debt instruments, shares and equity instruments, and derivatives with positive fair value which are not designated as hedging instruments.

Financial assets held for trading are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the income statement in "Net financial income", except for interest earned, which is recognised as "Interest income" on an accrual basis.

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

The Bank classifies certain financial assets upon their initial recognition as financial assets at fair value through profit or loss when doing so results in more relevant information because:

- it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank's risk management or investment strategy, and information about it is provided internally on that basis to the Bank's key management personnel.

Assets classified according to the above-mentioned conditions consist of:

- fixed interest rate loans originated by the Bank whose fixed interest has been swapped into floating by entering into corresponding interest rate swaps;
- debt and equity instruments which are acquired by the Bank with a view to profiting from their total return and which are managed and evaluated on a fair value basis.

Financial assets designated at fair value through profit or loss are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the income statement in "Net financial income", except for interest earned, which is recognised as "Interest income" on an accrual basis.

Notes to the Consolidated Financial Statements

3.4 Cont'd

c) *Loans and receivables*

Loans and receivables are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market and that the Bank does not intend to sell immediately or in the near term, other than those that the Bank designates upon initial recognition as financial assets at fair value through profit or loss. Loans and receivables include loans originated by the Bank to other banks and to its customers, participations in loans from other lenders and purchased loans.

Loans and receivables are recognised when cash is advanced to borrowers. They are measured at fair value on initial recognition, which is the cash given to originate the loan, including any transaction costs, and subsequently are measured at amortised cost using the effective interest method, less allowance for impairment. Amortised cost is calculated by taking into account any discount or premium on acquisition and fees and costs that are an integral part of the effective interest rate. Accrued interest is included in the carrying amount of the loans and receivables in the balance sheet. This is disclosed in more detail in note 2.5.

Gains and losses on loans and receivables are recognised in the income statement in 'Interest income' and 'Interest expense' when the loans and receivables are derecognised and in 'Currency exchange difference' when the loans and receivables are re-measured for foreign exchange differences. The losses arising from impairment are recognised in the income statement in "Net impairment losses on financial assets".

d) *Financial assets available-for-sale*

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

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

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

Reclassification of Held for Trading and Available for Sale financial assets that meet the definition of loans and receivables may be reclassified to loans and receivables if the Bank has the intention and ability to hold the financial asset for the foreseeable future or until maturity. Additionally, Held for trading financial assets that do not meet the definition of loans and receivables may, in rare circumstances, be transferred to Available for sale financial assets or to Held to Maturity investments.

Notes to the Consolidated Financial Statements

3.5 Financial liabilities

For the purpose of measurement, the Bank classifies its financial liabilities in the following categories: financial liabilities held for trading, financial liabilities designated at fair value through profit or loss, and financial liabilities measured at amortised cost. Management determines the classification of financial liabilities at initial recognition.

a) *Financial liabilities held for trading*

Financial liabilities held for trading are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities held for trading consist of short position in equity and bond instruments, and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities held for trading are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the income statement in "Net financial income", except for interest incurred, which is recognised as "Interest expense" on an accrual basis.

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

The Bank classifies certain financial liabilities upon their initial recognition as financial liabilities at fair value through profit or loss when doing so results in more relevant information because:

- it eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different basis; or
- financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Bank's risk management or investment strategy, and information about it is provided internally on that basis to the Bank's key management personnel.

Liabilities classified according to the above-mentioned conditions consist of:

- fixed rate deposits and fixed interest rate debt issued by the Bank whose fixed interest has been swapped into floating by entering into corresponding interest rate swaps;
- structured notes which are managed and evaluated on a fair value basis.

Financial liabilities designated at fair value through profit or loss are initially recognised and subsequently measured at fair value in the balance sheet with transaction costs taken directly to profit or loss. Changes in fair value are recognised in the income statement in "Net financial income", except for interest incurred, which is recognised as "Interest expense" on an accrual basis.

c) *Financial liabilities measured at amortised cost*

Financial liabilities measured at amortised cost are non-derivative financial liabilities which are not classified as financial liabilities held for trading or financial liabilities designated at fair value through profit or loss. Financial liabilities measured at amortised cost include deposits, debt issued and other borrowed funds and subordinated loans.

Financial liabilities measured at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account any discount or premium on the issue and fees and costs that are an integral part of the effective interest rate. Accrued interest is included in the carrying amount of the liabilities in the balance sheet.

Notes to the Consolidated Financial Statements

3.6 Determination of fair value of financial assets and financial liabilities

A number of the Bank's accounting policies and disclosures require the determination of fair value for measurement and / or disclosure purposes. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the reporting date date.

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. If a market for a financial instrument is not active, the Bank establishes fair value using valuation techniques. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques.

Valuation techniques include recent arm's length transactions between knowledgeable, willing parties, if available, reference to the current fair value of other instruments that are substantially the same, the discounted cash flow analysis and option pricing models. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Periodically, the Bank calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument, without modification or repackaging, or based on any available observable market data.

For more complex financial instruments, the Bank uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, in which case the inputs are derived from market prices or rates or estimated based on assumptions. The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value on the balance sheet.

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Bank recognises the difference between the transaction price and fair value in the income statement in "Net financial income" on initial recognition of the financial instrument. In cases where use is made of data which is not from observable markets, the difference between the transaction price and the value produced by the valuation technique, if any, is recognised in the income statement in "Net financial income", depending upon individual facts and circumstances of each transaction and not later than when the data becomes observable.

Notes to the Consolidated Financial Statements

3.7 Recognition and derecognition of financial assets and financial liabilities

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

The Bank derecognises financial assets when the contractual rights to the cash flows from the financial assets expire or when the Bank transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Bank is recognised as a separate asset or liability.

The Bank recognises financial liabilities held for trading and financial liabilities designated at fair value through profit or loss on the trade date at which the Bank becomes a party to the contractual provisions of the financial instrument. The Bank recognises financial liabilities measured at amortised cost on the date when they are originated. The Bank derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

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

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

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

3.8 Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount reported in the balance sheet when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

3.9 Derivative financial instruments

The Bank uses derivatives for trading. Derivatives which do not classify as equity instruments of the Bank are classified as financial assets or financial liabilities, measured at fair value and presented in the balance sheet as assets or liabilities, depending on whether their fair value at the balance sheet date is positive (assets) or negative (liabilities).

The method of recognising changes in fair value of derivatives depends on whether the derivatives are designated as hedging instruments, and if so, the nature of the item being hedged, as described below. Derivatives which the Bank does not designate or are not effective hedging instruments are classified as financial asset or financial liabilities held for trading and are accounted for in accordance with note 3.4(a) and 3.5(a) above.

Notes to the Consolidated Financial Statements

3.10 Leases

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

a) *Finance leases*

The Bank's receivables from leases classified as finance leases are included in the balance sheet in the line item "Loans and receivables". Finance leases are initially recognised at an amount equal to the net investment in the lease and subsequent lease payments are applied against the gross investment in the lease to reduce both the principal and the unearned finance income.

The Bank recognises its finance income as interest income based on a pattern reflecting a constant periodic rate of return on the Bank's net investment in the finance lease. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the finance lease receivable and therefore the initial direct costs are recognised over the lease term.

b) *Operating leases*

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

3.11 Investment property

The Bank holds certain properties as investments to earn rental income, for capital appreciation or both. Investment property is measured initially at cost, including transaction costs. Subsequently, investment property is measured at fair value, which reflects market conditions at the balance sheet date. Changes in the fair values are included in the income statement in "Other net operating income".

3.12 Property and equipment

a) *Owned assets*

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses, according to the cost model in IAS 16.

Where parts of an item of property and equipment have different useful lives, those components are accounted for as separate items of property and equipment.

b) *Subsequent costs*

The Bank recognises in the carrying amount of an item of property and equipment the cost of replacing part of such an item when that cost is incurred if it is probable that the future economic benefits embodied with the item will flow to the Bank and the cost of the item can be measured reliably. The decision if subsequent costs is added to the acquisition cost of the property or equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are recognised in the income statement as an expense as incurred.

c) *Depreciation*

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

Buildings	50 years
Fixtures	6 - 12 years
Machinery and equipment	4 years
Vehicles	3 years

The residual value is reassessed annually.

Notes to the Consolidated Financial Statements

3.13 Intangible assets

a) *Goodwill*

Where goodwill arises it is recognised as an asset in relation to the acquisition of businesses, for example through purchase of shares in subsidiaries or net assets of another entity. Goodwill relating to acquisition of associates is not recognised separately as an asset but is included in the carrying amount of the investments in associates in the balance sheet.

All business combinations are accounted for by applying the purchase method. In this respect, goodwill represents the difference between the cost of the acquisition and the fair value of the net identifiable assets acquired.

Goodwill is measured at cost less any accumulated impairment losses. Goodwill is allocated to cash-generating units and is tested for impairment annually and whenever there is an indication that the unit may be impaired.

Expenditure on internally generated goodwill and brands is recognised in the income statement as an expense as incurred.

b) *Other intangible assets*

Intangible assets other than goodwill that are acquired by the Bank are measured at cost less accumulated amortisation and impairment losses.

Other intangible assets are amortised from the date they are available for use.

c) *Subsequent expenditure*

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

d) *Amortisation*

Amortisation is charged to the income statement on a straight-line basis over the estimated useful lives of intangible assets. The Bank ascertained that the estimated useful life of software is four years. Goodwill is not amortised but it is systematically tested for impairment. Other intangible assets are amortised from the date they are available for use.

3.14 Non-current assets and disposal groups held for sale

Non-current assets (or disposal groups comprising assets and liabilities), including non-current assets (or disposal groups) acquired in a business combination, are classified as held for sale if the Bank expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets (or disposal groups) must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and their sale must be highly probable. Immediately before classification as held for sale, the measurement of all assets and liabilities in a disposal group is measured in accordance with the Bank's applicable accounting policies, except for non-current assets (or disposal groups) acquired in a business combination that are classified as held for sale, which are recognised at fair value less costs to sell. Thereafter, generally the assets and disposal groups classified as held for sale are measured at the lower of carrying amount and fair value less costs to sell.

Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in the income statement. Gains are not recognised in excess of any cumulative impairment losses.

Non-current assets and disposal groups held for sale are mainly foreclosed mortgages and subsidiaries held exclusively with a view to subsequent disposal.

3.15 Financial guarantees

Financial guarantee are contracts that require the Bank to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument.

Financial guarantees are recognised in the financial statements when they are issued and are included within "Other liabilities" in the balance sheet. Financial guarantees are initially measured at fair value, being the premium received. Subsequently, the Bank's liability under each guarantee is measured at the higher of the amortised premium and the best estimate of the expenditure required to settle any financial obligation arising as a result of the guarantee at the balance sheet date. The estimates are determined based on experience of similar transactions and history of past losses, supplemented by the judgement of management.

Any increase in the liability relating to financial guarantees is recognised in the income statement in "Other net operating income". The premium received is recognised in income statement in "Net fees and commission income" on a straight line basis over the life of each guarantee.

Notes to the Consolidated Financial Statements

3.16 Provisions

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

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the balance sheet date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows.

When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that reimbursement will be received and the amount of the receivable can be measured reliably.

a) *Onerous contracts*

Present obligations arising under onerous contracts are recognised and measured as provisions. An onerous contract is considered to exist where the Bank has a contract under which the unavoidable costs of meeting the obligations under the contract exceeds the economic benefits expected to be received under it.

b) *Restructuring*

A restructuring provision is recognised when the Bank has developed a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it. The measurement of a restructuring provision includes only the direct expenditures arising from the restructuring, which are those amounts that are both necessarily entailed by the restructuring and not associated with the ongoing activities of the entity.

c) *Contingent liabilities acquired in a business combination*

Contingent liabilities acquired in a business combination are initially measured at fair value at the date of acquisition.

At subsequent reporting dates, such contingent liabilities are measured at the higher of the amount that would be recognised in accordance with IAS 37 Provisions, contingent liabilities and contingent assets and the amount initially recognised less cumulative amortisation recognised in accordance with IAS 18 Revenue.

3.17 Subordinated loans

Subordinated loans are financial liabilities of the Bank which consist of liabilities in the form of subordinated loan capital which, in case of the Bank's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, the bonds are included within Tier I and Tier II, as shown in Note 74. On the one hand, there are subordinated loans with no maturity date that the Bank may retire only with the permission of the Financial Supervisory Authority. These loans qualify as Tier I capital in the calculation of the equity ratio.

3.18 Share capital

a) *Share capital*

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

b) *Dividends on shares*

Dividends are recognised as a deduction to equity in the period in which they are approved by the Bank's shareholders. Dividends declared after the balance sheet date are not recognised as a liability at the balance sheet date.

Notes to the Consolidated Financial Statements

3.19 Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash in hand, treasury bills, demand deposits with the central banks and with other credit institutions, short term loans to credit institutions and other liquid debt securities at floating interest rates. Cash and cash equivalents comprise balances with less than three months' maturity from the date of acquisition, and are used by the Bank in the management of its short-term commitments.

3.20 Interest income and expense

For all financial assets and financial liabilities measured at amortised cost and for debt instruments classified as financial assets available-for-sale (see notes 3.4 and 3.5), interest income and expense is recognised in the income statement using the effective interest method. For all financial assets and financial liabilities held for trading and for all financial assets and liabilities designated at fair value through profit or loss (see notes 3.4 and 3.5), interest income and expense is recognised in the income statement on an accrual basis (see note 9).

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Bank revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or expense. For floating rate instruments, interest income or expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate. Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

Interest income and expense include gains and losses on derecognition of loans and receivables and financial liabilities measured at amortised cost.

3.21 Fee and commission income and expense

Fees and commissions are generally recognised on an accrual basis when the service has been provided.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate on the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised on a straight-line basis over the commitment period. Loan syndication fees are recognised as revenue when the syndication has been completed and the Bank has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party – such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses – are recognised on completion of the underlying transaction. Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis. Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria are fulfilled.

Notes to the Consolidated Financial Statements

3.22 Net financial income

Net financial income consists of net gains on financial instruments held for trading, net gains on financial instruments designated at fair value through profit or loss, fair value adjustments in hedge accounting and net foreign exchange gains.

a) *Net gains on financial instruments held for trading*

Net gains on financial instruments held for trading comprise gains and losses related to financial assets and financial liabilities held for trading, and include all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below). Dividend income from financial assets held for trading is recognised in the income statement when the Bank's right to receive payment is established.

Gains and losses arising from changes in the fair value of derivatives that are classified as held for trading and which are economic hedges of financial assets or financial liabilities designated at fair value through profit or loss are included in "Net gains on financial instruments designated at fair value through profit or loss".

b) *Net gains on financial instruments designated at fair value through profit or loss*

Net gains on financial instruments designated at fair value through profit or loss comprise gains and losses related to financial assets and financial liabilities designated at fair value through profit or loss, and includes all realised and unrealised fair value changes, except for interest (which is included in "Interest income" and "Interest expense") and foreign exchange gains and losses (which are included in "Net foreign exchange gains" as described below). Dividend income from financial assets designated at fair value through profit or loss is recognised in the income statement when the Bank's right to receive payment is established.

Net gains on financial instruments designated at fair value through profit or loss also include gains and losses arising from changes in the fair value of derivatives that are classified as held for trading and which are economic hedges of financial assets or financial liabilities designated at fair value through profit or loss.

c) *Fair value adjustments in hedge accounting*

Fair value adjustments in hedge accounting comprises gains and losses arising from the entire change in fair value of hedging instruments in fair value hedges and gains and losses on hedged items attributable to the risks being hedged.

Notes to the Consolidated Financial Statements

3.22 Cont'd

d) *Net foreign exchange gains*

Net foreign exchange gains comprise all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in previous financial statements, except for differences arising on financial instruments designated as hedging instruments of net investments in foreign operations.

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

3.23 Impairment

The carrying amount of the Bank's assets, other than tax assets and financial assets measured at fair value with changes recognised in the income statement is reviewed at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment loss is recognised in the income statement whenever the carrying amount of an asset or of a cash-generating unit exceeds its recoverable amount.

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

a) *Impairment on loans and receivables*

If there is objective evidence that an impairment loss has been incurred on loans and receivables, their carrying amount is reduced through the use of an allowance account to the present value of expected future cash flows, discounted at their original effective interest rate. Losses expected as a result of future events, no matter how likely, are not recognised.

The criteria that the Bank uses to determine that there is objective evidence of an impairment loss include:

- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower (for example, equity ratio, net income percentage of sales);
- Breach of loan covenants or conditions;
- Initiation of bankruptcy proceedings;
- Deterioration of the borrower's competitive position;
- Deterioration in the value of collateral;
- Downgrading of an asset.

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed to the extent it is now excessive by reducing the loan impairment allowance account. The amount of any reversal is recognised in the income statement.

The Bank's management first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Loans and receivables that are not impaired individually become a part of a portfolio which is assessed for impairment. Collective assessment based on a portfolio assumes that loans and receivables have similar credit risk characteristics. Objective evidence of impairment of a group of loans and receivables exists if objective data indicates a decrease in expected future cash flows from a portfolio of loans and the decrease can be measured reliably but cannot be identified with the individual loans in the portfolio.

The recognition of interest income on impaired loans and receivables is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring impairment losses.

b) *Impairment on goodwill*

The Bank assesses whether there is any indication of impairment of goodwill on an annual basis. Goodwill is tested for impairment. Gains or losses realised on the disposal of subsidiaries include any unamortised balances of goodwill relating to the subsidiary disposed of.

Notes to the Consolidated Financial Statements

3.23 Cont'd

c) *Impairment on financial assets available-for-sale*

The Bank determines that available-for-sale equity investments are impaired when there has been a significant or prolonged decline in the fair value below its cost. This determination of what is significant or prolonged requires judgement. In making this judgement, the Bank evaluates among other factors, the normal volatility in share price. In addition, impairment may be appropriate when there is evidence of deterioration in the financial strength of the investee, industry and sector performance, changes in technology, and operational and financing cash flows. The amount of impairment loss is recognised in the income statement.

d) *Calculation of recoverable amount*

The recoverable amount of the Bank's loans and receivables is calculated as the present value of estimated future cash flows. The discount rate used for fixed rate loans and receivables is the effective interest rate computed at initial recognition. For variable rate loans and receivables the discount rate is the current effective interest rate.

The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

Loan write-offs:

When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined.

e) *Reversals of impairment*

An impairment loss in respect of financial assets carried at amortised cost is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

When a financial asset is acquired at a deep discount, credit losses have already occurred and are reflected in the purchase price. Such incurred credit losses are included in the estimated cash flows when computing the effective interest rate, as described in note 3.20. Any adjustments arising from revisions to estimated cash flows subsequent to initial recognition, e.g., recovery of previously incurred credit losses, are recognised as part of the carrying amount of the financial asset with a corresponding amount recognised in profit or loss.

An impairment loss in respect of an investment in a debt instrument classified as available-for-sale is reversed through the income statement while an impairment loss in respect of an investment in an equity instrument classified as available-for-sale is not reversed through income statement but through equity.

An impairment loss in respect of goodwill is not reversed.

In respect of other assets, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount.

An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

f) *Renegotiated loans*

Where possible, the Bank seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. Management continuously reviews renegotiated loans to ensure that all criteria are met and that future payments are likely to occur. The loans continue to be subject to an individual or collective impairment assessment.

Notes to the Consolidated Financial Statements

3.24 Income tax

Income tax on the profit or loss for the period comprises current and deferred tax. Income tax is recognised in the income statement except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

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

The deferred income tax asset / liability has been calculated and entered in the balance sheet. The calculation is based on the difference between balance sheet items as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration a carry forward tax loss. This difference is due to the fact that tax assessments are based on premises that differ from those governing the financial statements, mostly because revenues, especially of financial assets, are recognised earlier in the financial statements than in the tax return. A calculated tax asset is offset against income tax liability only if they are due to tax assessment from the same tax authorities.

A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

3.25 Administrative expenses

Administrative expenses consist of salary and related expenses, depreciation of property and equipment, amortisation of intangible assets and other administrative expenses, such as housing costs, advertising expenses and IT-related expenses.

3.26 Segment reporting

A business segment is a group of assets and operations engaged in providing products or services that are subject to risk and return that are different from those of other business segments. The Bank is organised into six main business segments: Retail banking, Corporate & Investment banking, Capital Markets, Asset Management, Treasury and Midengi.

3.27 Initial application of new standards and amendments to standards which had an effect on the consolidated financial statements of the Bank

The initial application of the following new standards and amendments to standards which became effective on or after 1 January 2009 affected the consolidated financial statements of the Bank:

- a) Amendments to IFRS 7 Financial Instruments: Disclosures – Improving Disclosures about Financial Instruments require enhanced disclosures about fair value measurements and liquidity risk in respect of financial instruments.

The amendments require that fair value measurement disclosures use a three-level fair value hierarchy that reflects the significance of the inputs used in measuring fair values of financial instruments. Specific disclosures are required when fair value measurements are categorised as Level 3 (significant unobservable inputs) in the fair value hierarchy. The amendments require that any significant transfers between Level 1 and Level 2 of the fair value hierarchy be disclosed separately, distinguishing between transfers into and out of each level. Furthermore, changes in valuation techniques from one period to another, including the reasons therefore, are required to be disclosed for each class of financial instruments. The disclosures in respect of fair values of financial instruments are provided in notes 7 and 8.

Notes to the Consolidated Financial Statements

3.27 Cont'd

Furthermore, the definition of liquidity risk has been amended and is now defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. The amendments require disclosure of a maturity analysis for non-derivative and derivative financial liabilities, although contractual maturities are required to be disclosed for derivative financial liabilities only when contractual maturities are essential for an understanding of the timing of cash flows. For issued financial guarantee contracts, the amendments require the maximum amount of the guarantee to be disclosed in the earliest period in which the guarantee could be called. The revised disclosures in respect of liquidity risk are provided in note 67.

Since the application of the amendments to IFRS 7 only impacts disclosure aspects, there is no impact on earnings per share.

- b) IFRS 8 Operating Segments introduced the "management approach" to segment reporting and replaced the requirement in IAS 14 Segment Reporting to determine primary (business) and secondary (geographical) reporting segments. The Bank concluded that the operating segments determined in accordance with IFRS 8 are the same as the business segments previously identified under IAS 14. The Bank has revised its presentation in accordance with the IFRS 8 presentation requirements to identify the chief operating decision maker per segment. Application of IFRS 8 only impacts presentation and disclosure aspects. Therefore, there is no impact on earnings per share. The IFRS 8 disclosures are provided in Note 5.
- c) IAS 1 Presentation of Financial Statements (revised 2007) introduced the term total comprehensive income, which represents changes in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners. Total comprehensive income may be presented in either a single statement of comprehensive income (effectively combining both the income statement and all non-owner changes in equity in a single statement), or in an income statement and a separate statement of comprehensive income. As of 1 January 2009 the Bank presents all recognised items of income and expense in a single statement of comprehensive income. Comparative information has been re-presented so that it also is in conformity with the revised standard. Since the application of IAS 1 (revised 2007) only impacts presentation aspects, there is no impact on earnings per share.

3.28 New standards and amendments to standards which had no effect on the consolidated financial statements of the Bank

The following new standards and amendments to standards which became effective on or after 1 January 2009 had no effect on the consolidated financial statements of the Bank:

- a) Amendment to IFRS 2 Share-based Payment – Vesting Conditions and Cancellations
- b) IAS 23 Borrowing Costs (revised 2007)
- c) Amendments to IAS 32 Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements – Puttable Financial Instruments and Obligations Arising on Liquidation
- d) Amendments to IFRIC 9 Reassessment of Embedded Derivatives and IAS 39 Financial Instruments: Recognition and Measurement – Embedded Derivatives
- e) Improvements to IFRSs issued in May 2008 (except for amendments to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, which become effective for the Bank's 2010 consolidated financial statements)
- f) IFRIC 13 Customer Loyalty Programmes
- g) IFRIC 15 Agreements for the Construction of Real Estate
- h) IFRIC 16 Hedges of a Net Investment in a Foreign Operation
- i) IFRIC 18 Transfers of Assets from Customers
- j) Improvements to IFRSs issued in May 2008 consisting of amendments to various standards which are applicable to the Bank's 2009 consolidated financial statements, except for amendments to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations, which become effective for the Bank's 2010 consolidated financial statements.

Notes to the Consolidated Financial Statements

3.29 New standards and amendments to standards adopted in advance by the Bank

The Bank has early adopted the revised IFRS 3 Business Combinations (2008) and the amendments to IAS 27 Consolidated and Separate Financial Statements (2008) in its consolidated financial statements for the year-ended December 2008. The Bank did not early adopt any other standards or amendments to standards which become effective on or after 1 January 2010.

3.30 New standards and amendments to standards effective on or after 1 January 2010 which have not been adopted in advance by the Bank

The following new standards and amendments to standards become effective on or after 1 January 2010 and have not been adopted in advance by the Bank:

- a) Amendments to IFRS 2 Share-based Payment – Group Cash-settled Share-based Payment Transaction require an entity receiving goods or services (receiving entity) in either an equity-settled or a cash-settled share-based payment transaction to account for the transaction in its separate or individual financial statements. This principle applies also if another group entity or shareholder settles the transaction (settling entity) and the receiving entity has no obligation to settle the payment. If endorsed by the EU, the amendments to IFRS 2 will become mandatory for the Bank's 2010 consolidated financial statements, with retrospective application required but subject to specific transitional provisions.

The Bank is currently in the process of evaluating the possible impact of these amendments on its consolidated financial statements.

- b) IFRS 9 Financial Instruments was issued in November 2009 and replaces those parts of IAS 39 relating to the classification and measurement of financial assets. The key features of IFRS 9 are the following:

- Financial assets are required to be classified into two measurement categories: those to be measured subsequently at fair value, and those to be measured subsequently at amortised cost. The decision is to be made at initial recognition. The classification depends on the entity's business model for managing its financial instruments and the contractual cash flow characteristics of the instrument.
- An instrument is subsequently measured at amortised cost only if it is a debt instrument and both the objective of the entity's business model is to hold the asset to collect the contractual cash flows, and the asset's contractual cash flows represent only payments of principal and interest (that is, it has only "basic loan features"). All other debt instruments are to be measured at fair value through profit or loss. The guidance in IAS 39 on impairment of financial assets and hedge accounting continues to apply.
- All equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other equity investments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses through other comprehensive income rather than profit or loss. There is to be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.
- Derivatives embedded in contracts with a host that is a financial asset within the scope of the standard are not to be separated; instead, the hybrid financial instrument is to be assessed in its entirety as to whether it should be measured at amortised cost or fair value.

If endorsed by the EU, IFRS 9 will become mandatory for the Bank's 2013 consolidated financial statements, with retrospective application required with certain exceptions. Earlier application of the standard is permitted and prior periods need not be restated if the Bank adopts the standard for reporting periods beginning before 1 January 2012.

The Bank is currently in the process of evaluating the potential effect of this standard and the timing of its adoption by the Bank. Given the nature of the Bank's operations, the standard is expected to have a pervasive impact on the consolidated financial statements of the Bank.

Notes to the Consolidated Financial Statements

3.30 Cont'd

- c) IAS 24 Related Party Disclosures (revised 2009) amends the definition of a related party and modifies certain related party disclosure requirements for government-related entities. If endorsed by the EU the revised IAS 24 will become mandatory for the Bank's 2011 consolidated financial statements, with retrospective application required. Earlier application is permitted, either of the whole standard or of the partial exemption for government-related entities.

The Bank is currently in the process of evaluating the possible impact of the revised IAS 24 on its consolidated financial statements.

- d) Amendment to IAS 32 Financial Instruments: Presentation – Classification of Rights Issues. The IASB amended IAS 32 to allow rights, options or warrants to acquire a fixed number of an entity's own equity instruments for a fixed amount of any currency to be classified as equity instruments provided the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. The amendment to IAS 32 will become mandatory for the Bank's 2011 consolidated financial statements, with earlier application permitted. The amendment must be applied retrospectively as it does not include any specific transitional provisions.

The Bank is currently in the process of evaluating the possible impact of this amendment on its consolidated financial statements.

- e) Amendments to IAS 39 Financial Instruments: Recognition and Measurement – Eligible Hedged Items clarifies the application of existing principles that determine whether specific risks or portions of cash flows are eligible for designation in a hedging relationship. The amendments will become mandatory for the Bank's 2010 consolidated financial statements, with retrospective application required.

These amendments are not expected to have a material impact on the consolidated financial statements of the Bank.

- f) Amendments to IFRS 5 Non-current Assets Held for Sale and Discontinued Operations (issued as part of the Improvements to IFRSs issued in May 2008) clarify that the Bank must classify all the assets and liabilities of a subsidiary as held for sale when the criteria set out in IFRS 5 are met and the Bank is committed to a sale plan involving loss of control of a subsidiary, regardless of whether the Bank will retain a non-controlling interest in its former subsidiary after the sale. In addition, the Bank will have to disclose the information required in respect of discontinued operations if the subsidiary is a disposal group that meets the definition of a discontinued operation in accordance with IFRS 5. The amendments to IFRS 5 will become mandatory for the Bank's 2010 consolidated financial statements, with prospective application required but subject to specific transitional provisions in IAS 27.

The Bank is currently in the process of evaluating the possible impact of these amendments on its consolidated financial statements.

- g) Improvements to IFRSs issued in April 2009 consist of 15 amendments to 12 various standards related to the presentation, recognition, measurement or disclosures requirements of those standards. If endorsed by the EU, these amendments will become mandatory for the Bank's 2010 consolidated financial statements.

No material changes to the accounting policies of the Bank are expected as a result of these amendments.

Notes to the Consolidated Financial Statements

3.30 Cont'd

- h)* Amendments to IFRIC 14 Prepayments of a Minimum Funding Requirement remove unintended consequences arising from the treatment of prepayments where there is a minimum funding requirement. These amendments result in prepayments of contributions in certain circumstances being recognised as an asset rather than an expense. If endorsed by the EU, these amendments will become mandatory for the Bank's 2011 consolidated financial statements, with retrospective application required.

These amendments are not expected to have a material impact on the consolidated financial statements of the Bank.

- i)* IFRIC 17 Distributions of Non-cash Assets to Owners provides guidance on when and how a liability for certain distributions of non-cash assets to owners acting in their capacity as owners is recognised and measured, and how to account for settlement of that liability. Distributions within the scope of IFRIC 17 are measured at the fair value of the assets to be distributed. Any gain or loss on settlement of the liability for the dividend payable is recognised in profit or loss. The scope of IFRS 5 was expanded to include distributions of non-cash assets to owners. IFRIC 17 becomes mandatory for the Bank's 2010 consolidated financial statements, with prospective application required.

IFRIC 17 is not expected to have a material impact on the consolidated financial statements of the Bank.

- j)* IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments addresses the accounting by an entity when the terms of its financial liabilities are renegotiated and result in the entity issuing equity instruments to its creditors to extinguish all or part of the financial liabilities. IFRIC 19 requires the entity to measure the equity instruments issued to its creditors to extinguish all or part of a financial liability at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured, in which case the equity instruments issued must be measured to reflect the fair value of the financial liability extinguished. If endorsed by the EU, IFRIC 19 becomes mandatory for the Bank's 2011 consolidated financial statements, with retrospective application required.

IFRIC 19 is not expected to have a material impact on the consolidated financial statements of the Bank.

Notes to the Consolidated Financial Statements

Business combination

4. Acquisition of group undertakings

At the end of December 2009 the Group acquired 100% of the share capital of Eik Properties ehf., a holding company for two subsidiaries, a property investments company in Iceland and a holding company for a property investments company in Norway. The Bank ascertains that the subsidiaries held for sale will be sold within a few months and they have been recognised as non-current assets and disposal groups held for sale according to IFRS 5 (see note 41).

The company was acquired at ISK 500,000 and was consolidated to the group on 31 December 2009.

Since the acquisition of Eik Properties ehf. took place very near to the year end 2009 reporting period, the Bank did not have the opportunity to obtain the necessary information to complete the measurement of the fair value of assets and liabilities. Provisional amounts disclosed for the assets and liabilities may be subject to adjustments following completion of the fair value measurement.

The estimated fair value measurement of the business combination takes into account the condition of and uncertainties in relation to the underlying assets and liabilities.

Employees of the business combination are not included in the full-time equivalent staff number of the Bank.

No goodwill arose on the acquisition.

Notes to the Consolidated Financial Statements

Business segments

5. Below is an overview showing the Bank's performance with a breakdown by business segments. A business segment is a distinguishable component of the Bank that is engaged in providing products or services that are subject to risks and rewards that may be different from those of other business segments. Transactions between the business segments are on normal commercial terms and conditions. Revenue sharing agreements are used to allocate external customer revenue to a business segment on a reasonable basis.

The accounting policies for the reportable segments are in line with the Bank's accounting policies. The segment profit presented is the profit reported to the chief operating decision maker for the purpose of resource allocation and assessment of segment performance.

In accordance with IFRS 8 the Bank is required to disclose business with a single customer that generates 10% or more of the combined revenue. The Bank has no such customer.

The Bank is organised into six main business segments:

- a) Retail Banking operates branches and asset-based financing. The branches provide services to individuals and small-and medium-sized enterprises. The Bank operates 21 branches in Iceland.
- b) Corporate and Investment Banking offers financial services and advisory services to larger corporations and investors. It operates internationally in two industry sectors: seafood and sustainable energy.
- c) Asset Management offers a range of wealth and asset management products and services for individuals, corporations and institutional investors.
- d) Capital Markets incorporates brokerage services in securities, foreign currencies and derivatives, sale of securities issues and money market lending.
- e) Midengi is a restructuring group which was formed specifically to manage businesses which the Bank has acquired through repossessions following loan defaults, debt restructuring and bankruptcies of its customers. The aim is to divest the businesses at the earliest opportunity at the same time as recovering as much as possible of the debt.
- f) Treasury incorporates funding and interbank functions for the Bank.

Cost centres comprise Head Office, Risk Management, Credit Control, Legal Department, Finance, Back Office, Branch Services, Operational Services, Quality Department, Software Solutions, Information Technology and Human Resources.

Indirect cost from support units is not allocated to the business segments.

The year 2009

Operations

	Retail Banking	Corporate & Investment Banking	Asset Management	Capital Markets	Midengi	Treasury	Cost centres & eliminations	Total
Net interest income	13,816	7,797	1,350	380	(1,285)	10,666	(741)	31,984
Net fee income	3,657	461	1,440	1,501	(51)	(122)	174	7,061
Net financial income	4,044	6,524	377	51	(467)	475	132	11,137
Other net operating income	19	24	61	30	1,884	0	743	2,761
Revised estimated future cash flows	8,669	6,427	2,630	8	0	368	318	18,419
Impairment	(7,330)	(17,778)	31	(0)	0	(1,432)	183	(26,326)
Administrative expenses	(5,701)	(459)	(768)	(279)	(146)	(1,017)	(7,744)	(16,113)
Other income	0	0	0	0	(294)	0	31	(263)
Profit before tax	17,174	2,996	5,121	1,692	(358)	8,938	(6,903)	28,660
Net segment revenue from external customers	14,781	30,788	1,017	1,971	82	2,941	1,363	52,943
Net segment revenue from other segments	6,756	(15,982)	2,210	(8)	0	8,079	(1,055)	0

Notes to the Consolidated Financial Statements

At 31 December 2009

	Retail Banking	Corporate & Investment Banking	Asset Management	Capital Markets	Midengi	Treasury	Cost centres & eliminations	Total
Total segment assets	299,175	191,092	14,720	2,536	9,846	201,724	(1,750)	717,342

15.10. - 31.12. 2008

Operations

	Retail Banking	Corporate & Investment Banking	Asset Management	Capital Markets	Midengi	Treasury	Cost centres & eliminations	Total
Net interest income	3,077	949	363	(2)	186	6,612	(584)	10,601
Net fee income	828	79	496	215	0	(26)	50	1,641
Net financial income	21,902	9,522	1,730	54	285	4,305	(228)	37,570
Other net operating income	23	13	2	44	10	0	613	703
Revised estimated future cash flows	953	306	24	0	0	1,965	0	3,248
Impairment	(23,066)	(9,546)	(1,771)	(3)	136	(12,340)	(410)	(47,002)
Administrative expenses	(1,296)	(119)	(167)	(89)	(0)	(664)	(1,750)	(4,085)
Other income	0	0	0	0	0	0	55	55
Profit before tax	2,421	1,204	676	218	616	(150)	(2,255)	2,730
Net segment revenue from external customers	19,600	14,482	1,976	320	480	13,620	36	50,514
Net segment revenue from other segments	6,229	(3,919)	614	(9)	0	(2,730)	(185)	0

At 31 December 2008

	Retail Banking	Corporate & Investment Banking	Asset Management	Capital Markets	Midengi	Treasury	Cost centres & eliminations	Total
Total segment assets	295,021	189,602	14,568	933	14,009	237,089	(93,219)	658,003

Notes to the Consolidated Financial Statements

Half year statements

6. Operations by half year:

2009	H2*	H1*	Total
Net interest income	19,753	12,231	31,984
Net fee and commission income	3,450	3,611	7,061
Net financial income	927	10,210	11,137
Other net operating income	1,901	859	2,760
Revised estimated cash flows	16,105	2,314	18,419
Net impairment losses	(14,887)	(11,439)	(26,326)
Administrative expenses	(8,195)	(7,918)	(16,113)
Other income (expenses)	128	(391)	(263)
Profit before income tax	19,182	9,477	28,659
Income tax	(3,306)	(1,372)	(4,678)
Profit for the period	15,876	8,105	23,982

*The split between H1 and H2 is unaudited

Financial assets and liabilities

7. The following table describes the carrying value of financial assets and financial liabilities. For instruments that are not recognised at fair value on the balance sheet the fair value has been estimated by discounting the cash flow, taking into account interest rate risk and credit risk. It is assumed that the pricing of interest rate risk and credit risk is consistent between assets and liabilities.

At 31 December 2009	Notes	Held for trading	Designated at fair value through P&L	Loans & receivables	Other amortised cost	Total carrying amount	Fair value
<i>Loans and receivables</i>							
Cash and balances with Central Bank	24			38,743		38,743	38,743
Loans to banks	29			87,416		87,416	87,416
Loans to customers	31			489,611		489,611	489,611
Loans and receivables		0	0	615,770	0	615,770	615,770
<i>Bonds and debt instruments</i>							
Listed		36,271	0			36,271	36,271
Unlisted			30,430			30,430	30,430
Bonds and debt instruments	27	36,271	30,430	0	0	66,701	66,701
<i>Shares and equity instruments</i>							
Listed		477	63			540	540
Unlisted			1,710			1,710	1,710
Shares and equity instruments	28	477	1,773	0	0	2,250	2,250
Total financial assets		36,748	32,203	615,770	0	684,721	684,721
<i>Financial liabilities</i>							
Financial liabilities	43	7,332				7,332	7,332
Deposits from Central Bank	44				28	28	28
Deposits from banks	44				139,064	139,064	143,752
Deposits from customers	45-46				339,659	339,659	339,659
Debt issued and other borrowed funds	47				69,190	69,190	69,190
Subordinated loans	48				24,843	24,843	24,843
Total financial liabilities		7,332	0	0	572,784	580,116	584,804

Notes to the Consolidated Financial Statements

7. Cont'd

At 31 December 2008		Held	Designated	Loans &	Other	Total
	Notes	for trading	at fair value through P&L	receivables	amortised cost	carrying amount
<i>Loans and receivables</i>						
Cash and balances with Central Bank	24			20,842		20,842
Loans to banks	29			28,320		28,320
Loans to customers	31			484,932		484,932
Loans and receivables		0	0	534,094	0	534,094
<i>Bonds and debt instruments</i>						
Listed		34,067				34,067
Bonds and debt instruments	27	34,067	0	0	0	34,067
<i>Shares and equity instruments</i>						
Listed		1,951	397			2,348
Unlisted			187			187
Shares and equity instruments	28	1,951	584	0	0	2,535
Share subscription				66,512		66,512
Derivatives	26	569				569
Total financial assets		36,587	584	600,606	0	637,777
<i>Financial liabilities</i>						
Financial liabilities	43	4,910				4,910
Derivatives	26	569				569
Deposits from Central Bank	44				53,153	53,153
Deposits from banks	44				103,400	103,400
Deposits from customers	45-46				336,695	336,695
Debt issued and other borrowed funds	47				67,315	67,315
Total financial liabilities		5,479	0	0	560,563	566,042

Most of the Bank's assets were acquired from Glitnir at a deep discount reflecting the large uncertainty around the recovery of those assets. That uncertainty still prevails. Under the current circumstances, where only a small part of the acquired portfolio has been restructured, the book value based on the initial valuation and an impairment test, is considered to provide the best estimate of the fair value of these assets.

The liability side is predominantly in the form of floating rate deposits. The fair value of the Bank's liabilities are in total estimated very close to its book value, the only exception being fixed rate deposits.

Notes to the Consolidated Financial Statements

Valuation of financial instruments

8. Fair value hierarchy

The table below analyses financial instruments carried at fair value, by valuation method. The different levels have been defined as follows:

Level 1: quoted prices (unadjusted) in active markets for identical assets or liabilities.

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

Level 3: inputs for the assets or liabilities that are not based on observable market data (unobservable inputs).

	Level 1	Level 2	Level 3	Total
Financial assets designated at FV through PL	63	30,430	1,710	32,203
Financial assets held for trading	36,748	0	0	36,748
	36,811	30,430	1,710	68,951
Financial liabilities held for trading	7,332	0	0	7,332
	7,332	0	0	7,332

Net interest income

9. Net interest income is specified as follows:

15.10. - 31.12.

2009 2008

Interest income:

Cash and cash balances with Central Bank	3,002	857
Loans and receivables	75,196	24,237
Financial assets held for trading	1,830	0
Financial assets designated at fair value through profit or loss	159	0
Financial assets share subscription	5,709	2,612
Other assets	1,016	13

Total interest income

86,913 27,719

Interest expenses:

Deposits from credit institutions and Central Bank	(11,045)	(3,661)
Deposits	(34,061)	(11,964)
Borrowings	(7,673)	(1,295)
Financial liabilities held for trading	(503)	(85)
Other interest expense	(1,647)	(112)

Total interest expenses

(54,929) (17,117)

Net interest income

31,984 10,602

Notes to the Consolidated Financial Statements

Net fee and commission income

10. Net fee and commission income is specified as follows:	15.10. - 31.12.	
	2009	2008
Fee and commission income:		
Asset management	1,302	453
Securities brokerage	363	112
Payment processing	3,327	903
Loans and guarantees	2,767	454
Foreign currency brokerage commission	1,519	182
Other fees and commissions income	852	117
Total fees and commission income	10,130	2,221
Commission expenses:		
Inter-bank charges	(988)	(233)
Brokerage	(89)	(23)
Clearing and settlement	(1,840)	(275)
Other commission expenses	(152)	(49)
Total commission expenses	(3,069)	(580)
Net fee and commission income	7,061	1,641

Net financial income

11. Net financial income is specified as follows:	15.10. - 31.12.	
	2009	2008
Net gain (loss) on financial instruments held for trading	142	(520)
Net gain (loss) on financial instruments designated at fair value through profit or loss	143	(29)
Net foreign exchange gain	10,852	38,118
Net financial income	11,137	37,570

Net gain (loss) on financial instruments held for trading

12. Net gain (loss) on financial instruments held for trading are specified as follows:	15.10. - 31.12.	
	2009	2008
Shares and related derivatives	177	(50)
Bonds and related derivatives	0	(469)
Other derivatives	(35)	0
Net gain (loss) on financial instruments held for trading	142	(520)

Notes to the Consolidated Financial Statements

Net gain (loss) on financial instruments designated at fair value through profit or loss

13. Net gain (loss) on financial instruments designated at fair value through profit or loss are specified as follows:	15.10. - 31.12.	
	2009	2008
Shares	131 (	29)
Bonds	12	0
Net gain (loss) on financial instruments designated at fair value through profit or loss	143	(29)

Net foreign exchange gain

14. Net foreign exchange gain is specified as follows:	15.10. - 31.12.	
	2009	2008
Assets:		
Cash and balances with Central Bank	44	39
Financial assets held for trading	1,946	4
Loans to banks	2,580	2,161
Loans to customers	16,289	49,099
Other assets	(52)	112
Total	20,807	51,416
Liabilities:		
Deposits banks	(3,170)	(7,788)
Deposits customers	(6,312)	(5,170)
Other liabilities	(473)	(340)
Total	(9,955)	(13,298)
Net foreign exchange gains	10,852	38,118

Other net operating income

15. Other net operating income is specified as follows:	15.10. - 31.12.	
	2009	2008
Rental income	141	31
Gain on investment property	0	428
Realised gain on property and equipment	1,698	0
Agency fees and SLA fees	568	208
Other net operating income	353	37
Other net operating income	2,760	703

Notes to the Consolidated Financial Statements

Administrative expenses

16. Administrative expenses are specified as follows:	15.10. - 31.12.	
	2009	2008
Salaries and related expenses	8,036	1,846
Other administrative expenses	7,569	2,123
Depreciation and amortisation	508	116
Administrative expenses	16,113	4,085

Included in other administrative expenses is ISK 672m or 0.15% of the average guaranteed deposit balance in 2009 as per note 55.

Staff and related expenses

17. Salaries and related expenses are specified as follows:	15.10. - 31.12.	
	2009	2008
Salaries	6,597	1,578
Pension and similar expenses	890	211
Social security charges	428	83
Reversal of accrued salaries	0 (	63)
Other	121	37
Salaries and related expenses	8,036	1,846

18. The Bank's total number of employees is as follows:	Parent	Total
	Company	
Average number of employees	899	1,039
Positions at the end of the year	842	981

Notes to the Consolidated Financial Statements

Employment terms for the Board of Directors and the CEO

19. Employment terms for the Board of Directors, the CEO and management board are specified as follows:

2009	Salaries and fringe benefits
Birna Einarsdóttir, CEO	24
Vilhjálmur H. Vilhjálmsson, Chairman of the Board	3
Other Board Members	8
6 MDs	114
Total	149

15.10. - 31.12. 2008	Salaries and fringe benefits
Birna Einarsdóttir, CEO	4
Vilhjálmur H. Vilhjálmsson, Chairman of the Board	0.4
Other board members	2
6 MDs	20
Total	26

Auditors' fees

20. Auditors' fees are specified as follows:

	2009	15.10. - 31.12. 2008
Audit of the annual accounts	107	0
Audit and review of interim accounts	11	0
Other services	9	4
Auditors' fees	127	4
Thereof remuneration to others than the auditors of the parent company	28	4

Net (loss) gain on non-current assets and disposal groups held for sale

21. Net (loss) gain on non-current assets and disposal groups held for sale are specified as follows:

	2009	15.10. - 31.12. 2008
Net (loss) gain from sale of foreclosed mortgages	(263)	1
Net (loss) gain on non-current assets classified as held for sale	(263)	1

Notes to the Consolidated Financial Statements

Effective income tax rate

22. The corporate income tax rate in Iceland for 2009 was 15.0%. The tax rate will increase to 18.0% with effective date from 1 January 2010. The effect of the increase in tax rate between the periods results in an increased tax charge relating to tax liabilities of ISK 59m which is recognised in the statement of comprehensive income in the current period. The effective income tax rate in the Bank's Income Statement for 2009 is 16.3%. The difference is specified as follows:

	15.10. - 31.12.			
	2009		2008	
Profit before tax	28,660		2,730	
15.0% income tax calculated on the profit of the year	4,299	15.0%	409	15.0%
Tax recognised outside profit and loss	406	1.4%	0	0.0%
Correction in accordance with ruling on prior years' taxable income	(10) (	0.0%)	0	0.0%
Other differences	(17) (	0.1%) (	45) (	1.6%)
Income tax according to the statement of comprehensive income	4,678	16.3%	364	13.4%

Earnings per share

23. Earnings per share are specified as follows:

	15.10. - 31.12.	
	2009	2008
Net profit of the equity holders of the parent, according to the financial statements	23,901	2,356
Average outstanding shares:		
Weighted average number of outstanding shares for the period, million	10,000	10,000
Basic Earnings per share, ISK	2.39	0.24
Average outstanding shares for the calculation of diluted earnings per share	10,000	10,000
Number of total shares at the end of the period, million, diluted	10,000	10,000
Diluted Earnings per share, ISK	2.39	0.24

Cash and balances with Central Bank

24. Specification of cash and cash balances with Central Bank:

	31.12.2009	31.12.2008
Cash on hand	1,842	1,906
Balances with Central Bank other than mandatory reserve deposits	10,707	12,584
Certificates of deposit	19,605	0
Included in cash and cash equivalents	32,155	14,490
Mandatory reserve deposits with Central Bank	6,588	6,352
Total	38,743	20,842

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 deposit money banks and other financial institutions and are not transferable except to other comparable institutions.

Notes to the Consolidated Financial Statements

Pledged assets

	31.12.2009	31.12.2008
25. Financial assets that have been pledged as collateral for liabilities	67,744	71,882

These transactions are conducted under terms that are usual and customary to standard lendings, and securities borrowing and lending activities, as well as requirements determined by exchanges where the Bank acts as an intermediary.

Derivative financial instruments

	Assets	Liabilities	Notional amount	Assets	Liabilities	Notional amount
	31.12.2009			31.12.2008		
26. Derivatives held for trading:						
FX swaps	0	0	0	569	569	12,289
Total	0	0	0	569	569	12,289

Bonds and debt instruments

	31.12.2009	31.12.2008
27. Specification of bonds and debt instruments:		
Listed.....	36,271	34,067
Unlisted.....	30,430	0
Total	66,701	34,067

Unlisted bonds and debt instruments consist of a Government bond.

Shares and equity instruments

	31.12.2009	31.12.2008
28. Specification of shares and equity instruments:		
Listed.....	540	2,348
Unlisted.....	1,710	187
Total	2,250	2,535

Notes to the Consolidated Financial Statements

Loans

29. Loans to banks:		31.12.2009	31.12.2008
Money market loans		16,198	21,071
Bank accounts		21,162	1,883
Other loans		50,056	5,366
Loans to banks		87,416	28,320

Other loans include 44bn in relation to Straumur (see note 58).

30. Loans to banks at amortised cost:		31.12.2009			31.12.2008	
		Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance
Loans to banks:						
Loans		88,009 (	593)	87,416	29,752	(1,432)
						28,320

31. Loans to customers:		31.12.2009	31.12.2008
Loans and advances to customers at amortised cost		489,611	484,933
Loans to customers		489,611	484,933

The above amount includes lease agreements of 18.7bn

32. Loans to customers at amortised cost:		31.12.2009			31.12.2008	
		Gross amount	Impairment allowance	Carrying amount	Gross amount	Impairment allowance
Loans to individuals		188,197 (	13,237)	174,959	189,880 (	11,334)
Loans to corporate entities		364,646 (	57,714)	306,932	331,207 (	33,356)
Central government and state-owned enterprises		4,472 (	490)	3,982	5,767 (	496)
Loans to municipalities		4,094 (	356)	3,738	3,651 (	384)
Total		561,409 (	71,798)	489,611	530,504 (	45,570)
						484,933

Notes to the Consolidated Financial Statements

33. Allowances for impairment:

	31.12.2009	31.12.2008
Specific allowances for impairment		
Balance at beginning of year	28,921	0
Charge to income statement	21,329	28,921
Recoveries	41	0
Write-offs	(695)	0
Balance at end of year	49,595	28,921
Collective allowances for impairment		
Balance at beginning of year	18,081	0
Write-offs	(283)	0
Charge to income statement	4,998	18,081
Balance at end of year	22,796	18,081
Allowances for impairment - loans to banks	593	1,432
Allowances for impairment - loans to customers	71,798	45,570
Total allowances for impairment	72,391	47,002
Total impairment charge	26,326	47,002

Specific allowances for impairment include impairment of foreign exchange gain for loans in a non-ISK contractual currency to borrowers with ISK-based income.

Investments in associates

	31.12.2009	31.12.2008
34. Changes in investments in associates:		
Investments in associates at the beginning of the year	651	296
Purchases of shares in associates	74	91
Sales of shares in associates	(83)	0
Transfers	185	210
Share of results	0	54
Investments in associates	827	651

Notes to the Consolidated Financial Statements

35. The Bank's interest in its principal associates, which are unlisted, are as follows:

	Ownership at year-end
Eignarhaldsfélagid Fasteign hf.	38.0%
GLB Glacier Renewable Fund	48.3%
Skeljungur hf.	49.0%
Reiknistofa Bankanna	23.5%
6 other associates	

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

	31.12.2009	31.12.2008
Total assets	82,982	100,782
Total liabilities	(63,539)	(80,378)
Net assets	19,443	20,404
Bank's share of net assets of associates	827	651
	15.10. - 31.12.	2009
Total revenue	9,178	6,534
Total loss in associates for the period	(4,518)	(6,114)
Bank's share of profits of associates	0	54

The Bank's share of losses in some associates exceeds the carrying amount of those associates and the Bank has discontinued to recognise its share of losses. The Bank is not under any obligation on behalf of its associates at year end and carrying amounts of those associates are reduced to nil at year end.

Investment in subsidiaries

36. The parent's interest in its subsidiaries is as follows:

	Location	Owner- ship
Kreditkort hf.	Iceland	55%
Borgun hf.	Iceland	55%
Íslandssjódir hf.	Iceland	100%
Midengi ehf.	Iceland	100%
Eik Properties ehf	Iceland	100%
Glitnir Asset Management AS	Luxembourg	100%
15 other wholly owned subsidiaries (SME)	Iceland	100%

Special purpose entity, Covered bond Fund, which was part of the Bank's Consolidated Financial Statements, was merged with the Parent Company at 1 November 2009.

Notes to the Consolidated Financial Statements

Related party disclosures

37. Parent and 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 related party transactions. For further information relating to the Bank's ownership see note 1.

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 year were based on general business terms of the Bank.

Related party transactions

The Bank has a related party relationship with its subsidiaries, the Board of Directors of the parent company, 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.

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

	31.12.2009	31.12.2008
Loans to the CEO and Managing Directors (including companies owned by them)	292	337
Loans to shareholders and Members of the Board (including companies owned by them)	32	37
Loans to associated companies and other related parties	35,089	28,407
	<hr/>	<hr/>
	35,413	28,781
Guarantees	135	80
Loan Commitments	222	5,136

Impairment allowances of ISK 671m have been recorded against balances outstanding during the period with related parties.

No share option programmes were operated during 2009. For salary terms of management see note 19.

Investment property

38. Investment property is specified as follows:

	31.12.2009	31.12.2008
Investment property at 1 January	1,679	1,589
Additions during the year	377	0
Revaluation during the year	0	90
	<hr/>	<hr/>
Investment property	2,056	1,679

Investment property valuations at period-end were based on estimated future cash flows.

Notes to the Consolidated Financial Statements

Property and equipment

39. Property and equipment are specified as follows:

	Real estate	Fixtures, equipment & vehicles	Total
Book value 15.10.2008 / Net acquisition through business combinations	175	1,598	1,773
Additions during the year	1	56	57
Depreciation during the year	(1) (	148) (	149)
Disposals during the year	0 (	5) (	5)
Book value 31.12.2008	175	1,501	1,675
Additions during the year	50	657	707
Depreciation during the year	(1) (	488) (	489)
Disposals during the year	(99) (	25) (	123)
Book value 31.12.2009	125	1,646	1,771
Total value as at 31.12.2008	176	1,649	1,825
Accumulated depreciation as at 31.12.2008	(1)	(148)	(149)
Book value 31.12.2008	175	1,501	1,675
Total value as at 31.12.2009	132	2,674	2,806
Accumulated depreciation as at 31.12.2009	(7) (	1,028) (	1,035)
Book value 31.12.2009	125	1,646	1,771
Official real estate value of buildings and leased land			265
Insurance value of buildings as at 31.12.2009			312
Insurance value of fixtures, equipment and vehicles as at 31.12.2009			1,827

Intangible assets

40. Intangible assets are specified as follows:

	Software
Intangible assets as at 1.1.2009	0
Additions during the year	127
Amortisation during the year	(20)
Intangible assets as at 31.12.2009	107

Notes to the Consolidated Financial Statements

Non-current assets and disposal groups held for sale

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

	31.12.2009	31.12.2008
Reposessed collateral	2,440	764
Assets of disposal groups classified as held for sale	16,574	1,390
Total	19,014	2,154

Reposessed collateral:

	31.12.2009	31.12.2008
Residential property	1,218	545
Industrial property	778	81
Equipment	99	114
Inventory	345	0
Other assets	0	24
Total	2,440	764

The Bank classified the assets and liabilities of its subsidiaries Eik Fasteignafélag hf. and Steypustöðin ehf. as assets and liabilities of disposal groups held for sale.

Since the acquisition of Eik Fasteignafélag took place very near to the year end 2009 reporting period, the Bank did not have the opportunity to obtain the necessary information to complete the measurement of the fair value of assets and liabilities. Provisional amounts for the assets and liabilities are reported in the Consolidated Financial Statements and may be subject to adjustments following completion of the fair value measurement.

Assets of disposal groups classified as held for sale:

	31.12.2009	31.12.2008
Cash	252	0
Investment properties	14,781	0
Equipment	733	803
Receivables	334	0
Inventory	10	0
Other assets	464	587
Total	16,574	1,390

Liabilities associated with assets classified as held for sale:

Payables	1,480	1,285
Borrowings and other liabilities	15,425	0
Total	16,905	1,285

Other assets

42. Other assets are specified as follows:

	31.12.2009	31.12.2008
Other receivables	4,041	5,294
Accruals	424	523
Prepaid expenses	179	85
Inventory (real estate)	3,761	7,350
Other assets	355	810
Other assets	8,761	14,062

The inventory comprises real estate which is valued at the lower of cost and net realisable value.

Notes to the Consolidated Financial Statements

Financial liabilities

43. Financial liabilities balances:

	31.12.2009	31.12.2008
Short positions in listed bonds	7,332	4,910
Financial liabilities	7,332	4,910

Deposits from Central Bank and banks

44. Deposits from Central Bank and banks are specified as follows:

	31.12.2009	31.12.2008
Repurchase agreements with Central Bank	28	53,153
Deposits from banks	139,064	103,400
Deposits from Central Bank and banks	139,092	156,553

Deposits from customers

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

	31.12.2009	31.12.2008
Demand deposits	205,652	227,705
Time deposits	134,006	108,990
Other deposits total	339,659	336,695

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

	31.12.2009		31.12.2008	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises.....	4,735	1%	4,113	1%
Municipalities.....	3,423	1%	2,766	1%
Other companies.....	180,944	53%	162,513	48%
Individuals.....	150,557	44%	167,304	50%
Other deposits total	339,659	100%	336,695	100%

Notes to the Consolidated Financial Statements

Debt issued and other borrowed funds

47. Specification of debt issued and other borrowed funds:	31.12.2009	31.12.2008
Issued bonds	56,828	0
Loans from banks	1,446	4,811
Debt issued to Glitnir banki hf.	0	62,504
Other debt securities	10,917	0
Total	69,190	67,315

Subordinated loans

48. Specification of subordinated loans:

	Currency	Interest	Maturity date	Book value 31.12.2009
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	EUR	4.7%	31.12.2019	24,843
Total Tier 2				24,843
Total subordinated loans				24,843

Subordinated loans include a Tier II government bond of EUR 138m (see note 1).

Tax assets and tax liabilities

49. Tax in the balance sheet:	31.12.2009		31.12.2008	
	Assets	Liabilities	Assets	Liabilities
Current tax	0	4,807	0	377
Deferred tax	84	354	5	172
Tax in the balance sheet	84	5,161	5	549

50. Changes in the deferred tax assets and the tax liabilities during the year are as follows:

	Assets	Liabilities
Tax assets and tax liabilities 15.10.2008	0	34
Calculated income tax for 2008	5	369
Income tax payable in 2009	0 (	231)
Deferred tax assets and tax liabilities 1.1.2009	5	172
Calculated income tax for 2009	79	4,644
Income tax payable in 2010	0 (	4,539)
Effect of the increase in tax rate	0	44
Income tax payable in 2010 correction due to 2008	0	33
Deferred tax assets and tax liabilities at the end of 2009	84	354

Notes to the Consolidated Financial Statements

51. The Bank's deferred tax assets and tax liabilities are attributable to the following balance sheet items:

	31.12.2009		31.12.2008	
	Assets	Liabilities	Assets	Liabilities
Property and equipment	0	69	0	81
Assets and liabilities denominated in foreign currencies	0	155	0	83
Effect of the increase in tax rate	0	45	0	0
Other intangible assets	0	3	0	0
Other items	84	82	5	9
Deferred tax assets and tax liabilities at the end of 2009	84	354	5	172

Other liabilities

52. Specification of other liabilities:

	31.12.2009	31.12.2008
Accruals	2,063	1,697
Liabilities to retailers for credit card provision	12,189	5,916
Guarantees	2,879	4,761
Chargeable gain tax	1,641	2,688
Unsettled securities transactions	64	1,058
Deferred income	135	67
Sundry liabilities	4,086	5,911
Total	23,057	22,097

Notes to the Consolidated Financial Statements

Equity

53. Share capital

Authorised share capital of the Bank is 10,000m ordinary shares of ISK 1 krona each. At 31.12.2009 paid up share capital totalled ISK 65,000m which is the total stated share capital of the Bank.

Issued share capital

	31.12.2009	31.12.2008
Ordinary fully paid shares of ISK 1 krona each	10,000	775
Ordinary unpaid shares of ISK 1 krona each	0	9,225
Total	10,000	10,000

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

Share premium account

	31.12.2009	31.12.2008
Premium arising on issue of equity shares	55,000	55,000
Total	55,000	55,000

Total share capital

	31.12.2009	31.12.2008
Ordinary share capital	10,000	10,000
Share premium account	55,000	55,000
Total	65,000	65,000

54. Other reserves are specified as follows:

	Other reserves	Total
Other reserves as at 15.10.2008	0	0
Translation differences	4	4
Contribution to statutory reserve	236	236
Other reserves as at 31.12.2008	240	240
Translation differences	2	2
Contribution to statutory reserve	1,817	1,817
Other reserves as at 31.12.2009	2,059	2,059

Notes to the Consolidated Financial Statements

Off balance sheet items

55. Obligations:

	31.12.2009	31.12.2008
Guarantees granted to customers	9,593	22,100
Committed undrawn lines of credit	5,165	12,500
Unused overdrafts	21,585	26,229
The Depositors and Investors Guarantee Fund – declaration of guarantee	3,697	3,276

The Depositors and Investors Guarantee Fund

The acquisition of guaranteed deposits from Glitnir carried with it an automatic exposure to claims from customers in case the Bank became insolvent. The claims are partly covered by assets in the Depositors and Investors Guarantee Fund (the Fund).

Total assets of the Fund shall amount to 1% of the average balance of guaranteed deposits held by commercial and savings banks in the preceding year. If the Fund is smaller than the 1%, the commercial and savings banks shall make an annual payment of 0.15% of their average guaranteed deposit balance for the preceding year. Total assets of the Securities Department shall amount to a minimum of ISK 100m.

If this payment of 0.15% does not result in the total assets of the Fund reaching the required amount of 1% of total average guaranteed deposits held, the banks are required to sign a declaration of guarantee for their share of the balance. At 31 December 2009 the parent company's declaration of guarantee amounted to ISK 3,697m.

The maximum payment that the Fund is allowed to charge the commercial and savings banks at any one time is 10% of the minimum size of the Fund and the amount is limited by the amount as stated in each declaration. However, this option only becomes exercisable in the event of a bankruptcy of any of the banks that results in the Fund being emptied. For 2009 the maximum annual charge that would be exercisable for each retail and savings bank is ISK 1,611m.

In accordance with the requirements of IAS37 to recognise a present obligation for past events, the Bank has recognised ISK 672m being 0.15% of the average guaranteed deposit balance in the current accounting period. The guarantee amount is disclosed as an off balance sheet item since it is not based on past events but is intended as a guarantee to cover possible future events.

The annual payment is likely to increase to 0.33% in the year 2010 as a result of a current review of the regulation.

Operating lease commitments

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

	31.12.2009	31.12.2008
Up to 1 year	517	488
1-5 years	1,537	2,641
Later than 5 years	5,909	6,186
	<u>7,963</u>	<u>9,315</u>

Balance of custody assets

57. Balance of custody assets:

	31.12.2009	31.12.2008
Custody assets	1,473,873	1,273,910

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

Notes to the Consolidated Financial Statements

Contingencies

58. Litigation threats

Several former customers of Glitnir private banking services have threatened litigation to claim compensation for alleged mistakes made by the employees of Glitnir. One customer has already filed a lawsuit against Íslandsbanki with the Reykjavík District Court. The Bank has not accepted any liability and will challenge the lawsuit on the grounds that these claims relate to events that happened prior to the incorporation of the Bank and the assignment of certain liabilities and assets on 15 October 2008 and consequently are not the responsibility of Íslandsbanki in any way. The Bank estimates the total amount of compensation liabilities claimed by customers of Glitnir to be ISK 5.5bn.

Netting agreement

When certain assets and obligations were transferred from Glitnir to the Bank, the FME ruled that the customers would, on liquidation of Glitnir, maintain their right to claim netting of assets and liabilities held by Glitnir prior to acquisition on 15 October 2008. As a result, the Bank anticipates that it may have to write off assets netted off against liabilities in Glitnir.

The Bank has made an agreement with Glitnir that the latter will compensate for losses that may result from the netting of assets and liabilities. The claims in question are priority claims on the liquidated assets of Glitnir and the netting exercise is unlikely to have any effect on either the asset value or the earnings of Íslandsbanki.

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 collaterals of customers, as applicable, due to claims and derivatives which were not transferred to the Bank. The Bank has, in accordance with this decision, transferred certain collateralised obligations of customers to Glitnir. One customer has already filed a lawsuit against Íslandsbanki with the Reykjavík District Court challenging the Bank's decision to transfer the customer's money market deposit to Glitnir, which the Bank has in good faith decided was deposited as collateral for a foreign exchange future contract. The claim is for approximately ISK 450m. Any future allocation of collateral will be done under an agreement with Glitnir where Glitnir indemnifies Íslandsbanki against any future claims against the Bank arising from the transfer of any such rights.

Indexed loans and foreign currency loans

The Bank has received several letters from attorneys representing its customers relating to possible or threatened lawsuits against the Bank. Firstly, claims may be set forward on the grounds that liability of certain customers has become void in part or whole due to foreign currency loans provided by the Bank to its customers, being deemed to be in breach of articles 13 and 14 of the Laws on Interest 38/2001 and therefore deemed unlawful. Secondly, in the case of the CPI indexed loans (CPI - Consumer Price Index), it is claimed that the increase in inflation has, due to recent events in the Icelandic economy, been far beyond the legitimate expectations of the borrowers and should therefore be declared null and void by the courts. Moreover, it is claimed that the loan obligations and their implementation is in conflict with article 36 of the Contract Laws 07/1936 which gives the Court the authority to change or declare void unreasonable or unfair provision in private contracts.

The Bank has challenged the claims made and maintains that the debt obligations are legal and valid. The Law on Interest 38/2001 does not sanction obligations in foreign currency nor does it state any given benchmarks, such as exchange rates of foreign currencies. The overriding principle in Icelandic Law is that contracts shall be upheld according to their terms.

No lawsuit has been filed in relation to the above and the Bank ascertains that it is unlikely that the loan obligations will be declared null and void or changed by the Courts. The Bank has not made any assumptions as to the possible financial effect of such lawsuits.

Dispute over the Bank's claim on Straumur

Following the takeover of Straumur-Burdarás Investment Bank hf. (Straumur) by the FME on 4 April 2009, the Bank assumed deposit obligations from Straumur for the value of ISK 45 billion. The Bank also provided Straumur with funds to meet obligations towards depositors in its Danish branch. As a payment, Straumur issued a bond guaranteed with a lien in roughly all of Straumur's assets. Deposits created in relation to settlement of prior debts were excluded.

The government committed to fund the Bank's liquidity needs in relation to the said obligations by lending government bonds to the Bank. If the Straumur bond is not fully paid by the end of the term of the bond, the Bank may hold the remaining government bonds without further obligations.

The Straumur Resolution Committee accepted and acknowledged the claim and the lien. However, some of creditors of Straumur have disputed the Bank's claim on the Straumur estate and the Resolution Committee has filed the dispute with the Reykjavík District Court.

The creditors claim that the Emergency Act passed on 6 October 2008, where deposits were moved up to priority ranking on bankruptcy, is unconstitutional and therefore illegal. The creditors claim that the bond and lien should never have been issued and are therefore void and should not enjoy priority ranking.

Negotiations between the Bank and the Straumur creditors are currently underway.

Notes to the Consolidated Financial Statements

Risk management

59. 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.

Risk governance

The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies.

The implementation of the risk management framework, limit setting and monitoring is delegated to the Risk Committee, the Asset and Liability Committee (ALCO) and the Executive Board. The members of those boards are appointed by the CEO.

The Risk Committee is responsible for supervising and monitoring the Bank's credit and concentration risks on a consolidated basis. The Risk Committee governs the Bank's credit policies and procedures. The Risk Committee can delegate authorisation power to its subcommittees.

The ALCO supervises market risk, liquidity risk, interest rate risk in the banking book, and the Bank's capitalisation. The ALCO decides on and set limits for market risk, liquidity risk and interest rate risk.

The Executive Board is responsible for the operational risk framework and for managing other risk factors such as reputational risk and business risk.

The compliance function is responsible for ensuring that the processes and the business conducted within the Bank are in accordance with external laws and regulations and internal directives and instructions.

Group Internal Audit conducts independent evaluations and provides assurance for the internal controls and risk management for its appropriateness, effectiveness and its compliance to the Bank's directives. The Chief Audit Executive (CAE) is appointed by the Board and accordingly has an independent position in the Bank's organisational chart. The CAE is responsible for internal audit within the Bank.

Credit risk

60. Credit risk is the primary risk factor in the Bank's operations. Credit risk is the risk of financial loss if a customer or counterparty to a financial instrument fails to meet its contractual obligations. Credit risk arises principally from the Bank's loans and advances to customers and other banks.

The Bank has policies and procedures dedicated to accepting, measuring, monitoring and controlling credit risk arising from all activities. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Bank's financial performance. A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations, forms the basis for all credit decisions. The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to industry segments. The Bank measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal criteria of connection between parties.

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security for funds advances, which is common in practice. The principal collateral types for loans are:

- Mortgages over residential properties;
- Charges over business assets such as premises, inventory and accounts receivable;
- Charges over financial instruments such as debt securities and equities.

When applicable, other credit risk mitigants are employed.

Notes to the Consolidated Financial Statements

Credit exposure

61. The following table presents the maximum exposure to credit risk of on balance sheet and off balance sheet financial instruments, before taking account of any collateral held or other credit enhancements.

	Maximum exposure	
	31.12.2009	31.12.2008
Cash and balances with Central Bank	38,743	20,842
Loans to banks	87,416	28,320
Loans to customers:		
Loans to individuals	174,960	174,047
Loans to corporate entities	306,931	302,348
Loans to central government and state-owned enterprises	3,982	5,271
Loans to municipalities	3,738	3,267
Bonds and debt instruments:		
Central government	66,268	34,067
Local governments	59	0
Other	374	0
Derivatives	0	569
Other assets	8,761	14,062
	691,232	582,793
Financial guarantees	9,593	22,100
Loan commitments	5,165	12,500
	14,758	34,600
Total	705,990	617,393

Collateral and other credit mitigants vary between types of exposure. Loans to banks are often unsecured although a large part of the Íslandsbanki exposure to banks is guaranteed by a third party. For loans to individuals the principal collateral taken is mortgage over residential property. In the case of corporate entities the Bank takes a charge over fixed and current assets as well as employing covenants in loan agreements. Government loans and loans to municipalities are usually unsecured. Derivative activity is generally documented by ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash or government bonds.

Notes to the Consolidated Financial Statements

62. Past due but not impaired loans are loans where contractual interest or principal payments are past due but specific impairment is not appropriate. Amounts reported as past due refer to the total loan exposure to that particular customer and not only the payment or sum of payments that are past due.

Loans are summarised as follows:

	Neither past due nor impaired	Past due but not impaired	Impaired	Total
At 31 December 2009				
Loans to banks.....	85,057	1,424	935	87,416
Loans to individuals.....	111,842	24,215	38,903	174,960
Loans to corporate entities.....	80,070	19,093	207,768	306,930
Loans to central government and state-owned enterprises.....	2,056	9	1,917	3,982
Loans to municipalities.....	1,787	623	1,327	3,738
Total	280,812	45,364	250,849	577,025

	Neither past due nor impaired	Past due but not impaired	Impaired	Total
At 31 December 2008				
Loans to banks.....	26,981	0	1,339	28,320
Loans to individuals.....	116,818	15,978	41,176	173,972
Loans to corporate entities.....	134,943	27,511	139,971	302,426
Loans to central government and state-owned enterprises.....	3,301	210	1,758	5,269
Loans to municipalities.....	1,178	11	2,077	3,266
Total	283,221	43,710	186,321	513,252

63. Gross amount of loans by class to customers that were past due but not impaired were as follows:

	Past due up to 30 days	Past due 30-60 days	Past due 60-90 days	Over 90 days	Total
At 31 December 2009					
Loans to banks.....	0	0	45	1,379	1,424
Loans to individuals.....	5,914	2,173	628	15,500	24,215
Loans to corporate entities.....	1,784	2,593	1,455	13,262	19,093
Loans to central government and state-owned enterprises.....	6	0	0	3	9
Loans to municipalities.....	0	0	0	623	623
Total	7,704	4,766	2,128	30,767	45,364

At 31 December 2008					
Loans to individual (retail customers).....	6,101	3,794	912	5,171	15,978
Loans to corporate entities.....	7,704	5,591	8,951	5,265	27,511
Loans to central government and state-owned enterprises.....	203	0	7	0	210
Loans to municipalities.....	11	0	0	0	11
Total	14,019	9,385	9,870	10,436	43,710

The majority of past due loans are loans that were acquired from Glitnir at a deep discount and there is a significant difference between claim value and book value of these loans. The loans are in the process of being restructured. There are many that have been in some sort of payment holiday or other loan modification plan but are now considered past due and others are in a legal process.

Notes to the Consolidated Financial Statements

64. The following table breaks down the Bank's credit exposure by industry sectors based on carrying amounts.

	31.12.2009	31.12.2008
Individuals.....	30%	34%
Financial institutions.....	15%	6%
Real estate.....	13%	13%
Seafood.....	12%	15%
Investment companies.....	9%	11%
Commerce.....	5%	4%
Industry.....	4%	7%
Construction.....	4%	3%
Services.....	4%	4%
Transportation.....	1%	1%
Other.....	3%	2%
	100%	100%

65. Large Exposure Disclosure

A large exposure is defined as an exposure to a group of connected clients which exceeds 10% of the Bank's capital base. The exposure is evaluated net of credit risk mitigating effects eligible according to FME rules no 216/2007.

The Bank has four large exposures that total less than 64% of the Bank's capital base. No large exposure exceeds the maximum 25% set by the FME rules.

66. The Bank obtained assets by taking possession of collateral held as security as follows:

	31.12.2009	31.12.2008
Residential property.....	1,218	545
Industrial property.....	778	81
Equipment.....	99	114
Other assets.....	345	345
Total	2,440	1,085

Notes to the Consolidated Financial Statements

Liquidity risk

67. Liquidity risk is the risk that the Bank will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities, or will only be able to do so substantially above the prevailing market cost of funds. The risk mainly arises from mismatches in the timing of cash flows.

Liquidity risk management

The Bank's main source of funding is customer deposits. The Bank's Treasury function is responsible for the Bank's funding and its day-to-day liquidity management.

The ALM & Capital Management unit within Risk Management is responsible for measuring, monitoring and reporting on the Bank's liquidity position.

The Bank's liquidity risk management policy assumes that the Bank has at all times sufficient liquidity to meet liabilities maturing over the next 12 months.

When determining the expected maturity of liabilities the Bank generally assumes that the counterparty will require repayment at the first possible date. An exception is made in the case of deposits where expected maturities are based on historical stability of the deposit base. All unrecognised loan commitments are expected to be met at the first possible execution date. For long-term liabilities, the maturity profile is based on the contractual amortisation structure.

The Bank's liquidity position is reported to the Central Bank every month, based on expected maturities as defined by the Central Bank. At the end of December 2009, the reported one- and three- month Central Bank liquidity ratios were 2.6 and 2.7 respectively, as compared to the minimum of 1.0.

The following table shows the Bank's contractual maturity profile on 31 December 2009, including both on and off balance sheet items. The analysis is based on the period remaining until the contractual maturity according to the requirements under IFRS7. These figures are based on undiscounted cash flows and do not include future interest payments. The cash flows are based on the assumption that the counterparty will require repayment at the first possible date. Hence, most customer deposits fall into the first time bucket.

There is a material difference between the expected maturity profile of liabilities used for internal liquidity reporting and the contractual maturity profile which is displayed in the table below.

Maturity analysis 31 December 2009

On balance sheet financial liabilities - contractual undiscounted cashflows	Up to 1 month	1-3 months	3-6 months	6-12 months	1-2 years	2-5 years	Over 5 years	Total
Financial liabilities	7,332	0	0	0	0	0	0	7,332
Deposits from Central Bank	28	0	0	0	0	0	0	28
Deposits from banks	128,103	1,390	0	0	79	9,492	0	139,064
Deposits from customers	283,501	15,231	504	507	813	33,209	5,894	339,659
Debt issued and other borrowed funds .	462	981	0	0	8,463	0	59,284	69,190
Subordinated loans	0	0	0	0	0	0	24,843	24,843
Total financial liabilities	419,425	17,602	504	507	9,355	42,701	90,021	580,114
Other liabilities and equity								
Other liabilities	8,675	0	0	0	0	0	36,450	45,125
Equity	0	0	0	0	0	0	92,103	92,103
Total liabilities and equity	428,099	17,602	504	507	9,355	42,701	218,574	717,342
Total assets	230,244	12,991	19,415	58,776	77,959	114,647	203,310	717,342
Total maturity gap on 31 December 2009	(197,855)	(4,611)	18,911	58,269	68,604	71,946	(15,264)	0
Off balance sheet liabilities	14,758							
Total maturity gap on 31 December 2008	(231,109)	38,624	16,397	33,694	58,379	46,563	37,452	0

Notes to the Consolidated Financial Statements

Market risk

68. The objective of market risk management is to manage and control market risk exposures within acceptable parameters.

Definition of market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates, interest rates, credit spreads and equity prices, will affect the fair value or future cash flows of the Bank's financial instruments. The Bank separates exposures to market risk into trading book and banking book (non-trading book).

The Bank's primary sources of market risk in the trading book are shares, debt instruments and foreign currency positions. Shares and equity instruments are held for trading and market making. Bonds and debt instruments are held for trading and market making and consist mainly of fixed income securities such as Government bonds. All financial assets and liabilities in the trading book are recognised at fair value and all resulting changes are immediately reflected in the income statement.

Market risk management

The market risk unit is responsible for monitoring the Bank's exposure towards market risk in the trading book and the Bank's equity exposure in the banking book and reporting consolidated risk figures to management. The market risk unit ensures that the Bank's exposure to risk is in line with the Bank's policies and risk profile as determined by the Board of Directors. The Bank's market risk limits are set by the ALCO and consist of conventional risk measures such as market value and sensitivity measures.

Investments in financial instruments

Shares and equity instruments

The Bank's equity exposure arises from proprietary trading, market making and investment activities, mainly in shares denominated in ISK. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the concentration risk in the Bank's portfolio.

Investments in shares in the banking book are partly due to restructuring of companies in distress which the Bank has taken over. The investments may not have been entered into as part of the Bank's pre-defined strategy as outlined in the Market risk policy, but are nevertheless an essential part of the restructuring of the Bank's assets.

			31.12.2009
Shares and equity instruments	Listed	Unlisted	Total
Trading book.....	477	0	477
Banking book.....	63	1,710	1,773
Total Shares and equity instruments	540	1,710	2,250

Bonds and debt instruments

The fixed income trading unit invests in government bonds and bonds issued by the Housing Financing Fund (HFF). Government bonds are non-indexed with duration up to seven years. HFF bonds are linked to the Consumer Price Index (CPI) in Iceland and have a duration of up to 14 years. The Bank uses sensitivity measures like Basis Point Value (BPV) to manage the risk arising from these exposures. The BPV measures the effect of a 0.01% parallel shift in the yield curve on the bond position.

Bonds and debt instruments held for trading

<i>Assets</i>	Market Value	Duration	BPV
Indexed.....	2,800	6.51	-1.82
Non-Indexed.....	33,471	0.83	-2.78
<i>Liabilities</i>	Market Value	Duration	BPV
Indexed.....	2,707	5.27	1.43
Non-Indexed.....	4,625	1.12	0.52
Total bonds and debt instruments held for trading (net position)	28,939	0.92	-2.66

Notes to the Consolidated Financial Statements

68. Cont'd

The Bank holds a significant amount of foreign triple-A credit rated T-bills in its liquidity portfolio. Duration ranges up to six months and the sensitivity measured in BPV is ISK 0.7 million. Domestic government bonds are held for trading in the Bank's market making and proprietary portfolios. The Bank also has a Government bond issue designated at fair value as an equity contribution from the Icelandic state of ISK 30,000m. The bond pays floating rates and carries relatively low interest rate risk.

Fair value bonds and debt instruments, specified by issuer	Total	BPV
Domestic Government.....	29,411	-2.74
Foreign Governments.....	29,584	-0.69
Other.....	375	0.00
Total fair value bonds and debt instruments, specified by issuer	59,369 (	3.43)

Sensitivity analysis using conventional risk measures

The Bank calculates Value-at-Risk (VaR) for the currency exposure using 95% confidence level and both a 1-day and a 10-day holding period.

The interest rate risk for bonds and debt instruments is calculated as the risk of loss from parallel shift of the yield curve of 100 basis points (1 percentage point). Inflation risk in the trading book is minimal and not separately reported. It is included in the Bank's total exposure to CPI (see note 71).

The BPV for the indexed and non-indexed bonds is -0,40 million and -2,26 million, respectively. This means that a 0.01% parallel upward (downward) shift in the yield curve will decrease (increase) the value of the indexed and non-indexed bonds by approximately 0,40 million and 2,26 million, respectively.

Currency exposure (VaR, 95% confidence level, 1- and 10-day holding period)

1-day holding period.....	527
10-day holding period.....	2,461

IR (Shift on IR 100bp)

Shift on yield curve 100bp.....	343
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Prices (Equity)

Trading.....	181
Banking.....	2,070

Notes to the Consolidated Financial Statements

Interest rate risk in the banking book

69. Interest rate risk is the risk that the Bank will experience deterioration in its financial position as interest rates change over time.

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 market interest rates change over time, reflecting the fact that the Bank's assets and liabilities are of different maturities and are priced off different interest rates.

Management of interest rate risk in the banking book

The ALM & Capital Management unit within Risk Management is responsible for measuring, monitoring and reporting on the Bank's interest rate risk in the banking book. The Treasury unit is responsible for managing the Bank's interest rate risk within limits set by ALCO.

The management of interest rate risk in the banking book is supplemented by monitoring the sensitivity of the Bank's financial assets, financial liabilities and earnings towards changes in the underlying interest rates. Standard scenarios include an adverse 100 basis point parallel shift in all yield curves.

At the end of 2009, a 100 basis point adverse parallel shift in yield curves would result in a loss of ISK 1.2bn.

Interest gap analysis 31 December, 2009

Assets	Over						Other	Total
	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	10 years		
Cash and balances with Central Bank ..	36,901	0	0	0	0	0	1,842	38,743
Bonds and debt instruments	49,493	9,447	2,618	0	0	5,144	0	66,701
Shares and equity instruments	0	0	0	0	0	0	2,250	2,250
Loans to banks	84,493	2,892	0	0	0	31	0	87,416
Loans to customers	380,548	61,985	17,129	7,973	3,494	18,482	0	489,611
Investments in associates	0	0	0	0	0	139	688	827
Other assets	3,777	0	0	0	0	1,846	26,170	31,793
Total assets	555,212	74,324	19,747	7,973	3,494	25,642	30,950	717,342
Liabilities								
Financial liabilities	3,099	0	0	3,480	0	753	0	7,332
Deposits from Central Bank	28	0	0	0	0	0	0	28
Deposits from banks	132,091	0	0	6,973	0	0	0	139,064
Deposits from customers	339,659	0	0	0	0	0	0	339,659
Debt issued and other borrowed funds .	5,210	0	0	649	56,828	0	6,503	69,190
Subordinated loans	24,843	0	0	0	0	0	0	24,843
Other liabilities	0	0	0	0	0	0	45,123	45,123
Equity	0	0	0	0	0	0	92,103	92,103
Total liabilities	504,930	0	0	11,102	56,828	753	143,729	717,342
Net interest gap on 31 December 2009	50,282	74,324	19,747 (	3,129) (	53,334)	24,889 (	112,779)	0
Net interest gap on 31 December 2008	(141,617)	59,083	43,664	23,466	4,882	11,409 (	887)	0

Notes to the Consolidated Financial Statements

Currency risk

70. Currency risk arises when financial instruments are not denominated in the reporting currency and can both affect the Bank's income and balance sheet.

Management of currency risk

The currency balance presented below is based on the contractual currency of the underlying assets and liabilities. However, most of the net currency imbalance is due to loans with a non-ISK contractual currency to borrowers with ISK-based income (FX/ISK loans). As part of the transfer of assets from Glitnir the Bank determined that these loans have recovery value that is limited in ISK terms. There has been a significant devaluation of the ISK since the transfer of assets. To reflect the ISK based recovery value of these loans the Bank has impaired fully the foreign exchange gains on these assets since the date of transfer. Should there be an appreciation of the ISK there will be a corresponding reversal of the impairment charge. This is in accordance with IFRS. The accumulated FX impairment charge stands at ISK 37.4bn.

The Bank's regulators allow for an adjustment of the contractual currency imbalance to reflect the above limits to the recovery of foreign currency denominated loans to customers with ISK-based income. The table below summarises the Bank's exposure to currency risk at 31 December 2009 based on contractual currencies along with the adjusted balance.

Currency analysis 31 December 2009

Assets	ISK	EUR	USD	GBP	CHF	JPY	Other	Total
Cash and balances with Central Bank ..	36,677	462	606	148	45	17	788	38,743
Bonds and debt instruments	36,742	0	11,105	8,954	0	0	9,900	66,701
Shares and equity instruments	2,250	0	0	0	0	0	0	2,250
Loans to banks	55,040	13,113	10,481	2,048	1,722	114	4,898	87,416
Loans to customers	240,672	96,916	30,478	5,269	56,334	49,343	10,599	489,611
Investments in associates	827	0	0	0	0	0	0	827
Other assets	31,650	0	0	0	0	0	144	31,794
Total assets	403,858	110,491	52,670	16,419	58,101	49,474	26,329	717,342
Liabilities								
Financial liabilities	7,332	0	0	0	0	0	0	7,332
Deposits from Central Bank	28	0	0	0	0	0	0	28
Deposits from banks	92,766	7,194	15,070	8,986	0	11	15,038	139,064
Deposits from customers	294,377	20,240	14,127	4,704	223	1,033	4,955	339,659
Debt issued and other borrowed funds .	69,053	0	0	0	0	0	137	69,190
Subordinated loans	0	24,843	0	0	0	0	0	24,843
Other liabilities	45,120	0	0	0	0	0	3	45,123
Equity	92,103	0	0	0	0	0	0	92,103
Total liabilities	600,779	52,277	29,197	13,690	223	1,044	20,133	717,342
Non-adjusted foreign currency imbalance	(196,921)	58,214	23,473	2,729	57,878	48,430	6,197	0
Adjustment of currency imbalance for FX/ISK loans	(157,998)	55,224	21,530	1,707	39,923	35,647	3,968	0
Net currency imbalance on 31 December 2009	(38,923)	2,990	1,943	1,022	17,955	12,783	2,229	0
Net currency imbalance on 31 December 2008	2,660 (	33,821) (	8,240) (	816)	21,019	12,504	6,696	0

Notes to the Consolidated Financial Statements

Exposure towards inflation

71. The Bank is exposed to Icelandic inflation since the Consumer Price Index (CPI) indexed assets exceed the CPI-indexed liabilities. All indexed assets and liabilities are valued according to the CPI measure at any given time and changes in the CPI are recognised in profit and loss. Mismatch in the CPI-indexed assets and liabilities are reported to ALCO. On 31 December 2009 the CPI gap amounted to ISK 27bn.

Capital management

Risk exposure and capital base

72. Icelandic capital adequacy rules are based on the EU capital requirements directives (CRD). The capital adequacy rules require an absolute minimum capital level of 8% of risk weighted assets.

As part of the conditions for granting the Bank an operating license as a financial undertaking, the Icelandic financial supervisory authority (FME) requires the bank to maintain a minimum Core Tier 1 ratio of 12% of risk weighted assets and a solvency ratio, allowing for subordinated Tier 2 debt, of 16%.

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 70.

The table below shows the capital base, risk weighted assets and capital ratios of Íslandsbanki on 31 December 2009 and 2008.

	2009	2008
Tier 1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	2,059	240
Retained earnings	24,204	2,120
Minority interest	840	670
Intangible assets	(107)	0
Total Tier 1 capital	91,996	68,030
Tier 2 capital		
Qualifying subordinated liabilities	24,843	0
Total regulatory capital	116,839	68,030
Risk weighted assets		
- due to credit risk	454,773	413,800
- due to market risk	42,117	49,688
Market risk, trading book	3,195	7,125
Currency risk FX	38,922	42,563
- due to operational risk	92,929	55,388
Total risk weighted assets	589,819	518,875
Capital ratios		
Tier 1 ratio	15.6%	13.1%
Total capital ratio	19.8%	13.1%

In 2009, the Bank did an assessment of its internal capital adequacy (ICAAP). Such an assessment is an integral part of the Bank's capital and risk management. Current capitalisation levels are well above the requirements of the ICAAP.

Notes to the Consolidated Financial Statements

Operational risk

73. Operational risk is a part of the basis for calculating capital requirements of financial institutions. This is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

The Bank has implemented an operational risk management framework which satisfies the requirements for the Standardised Approach under the Basel II Accord with respect to assessment, monitoring and control of operational risk. Under this framework, operational risk management will be carried out in a consistent manner across all business units in the Bank with the primary responsibility for the assessment and managing of operational risk residing with each business unit.

The Bank uses the basic indicator approach of the Capital Requirements Directive (CRD) to calculate capital requirements for operational risk. Capital requirements for operational risk are calculated as 15% of net income.

The Bank's operational risk losses are registered into the Loss Event Data (LED) system.

Failures in execution, delivery and process management accounted for 45% of the total loss amount in 2009. Included in that category was the year's single largest loss, which accounted for 16% of the total loss amount.