Íslandsbanki

Consolidated Financial Statements 2018

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Contents

Highlights

Íslandsbanki

Our profile

- A leader in financial services in Iceland, Íslandsbanki is a universal bank with total assets of ISK 1,130bn and a 25%-50% market share across all domestic business segments.
- Building on over 140 years of servicing key industries, Íslandsbanki has developed specific expertise in tourism, seafood and energy related industries.
- Driven by the vision to be #1 for service, Íslandsbanki's relationship banking business model is propelled by three business divisions that manage and build relationships with the Bank's customers.
- Íslandsbanki has developed a wide range of online services such as the Íslandsbanki, and Kass apps, enabling customers to do their banking whenever and wherever. At the same time, the Bank continues to operate the most efficient branch network in Iceland through its strategically located 14 branches.
- In 2018, Íslandsbanki led the Icelandic Customer Satisfactory Index for banks for the sixth consecutive year and in July 2018, Euromoney selected Íslandsbanki as the best bank in Iceland.
- Íslandsbanki has a BBB+/A-2 rating from S&P Global Ratings.

Our Bank

14 branches

834 Number of FTE´s for parent company at year-end

81.500 APP users

Market Share*

32% individuals

37% SMEs

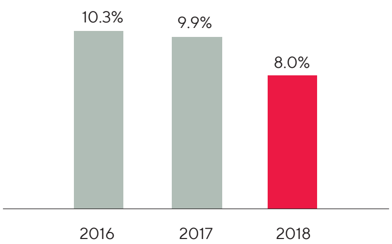
33% large companies and investors

Credit Rating

S&P Global Ratings

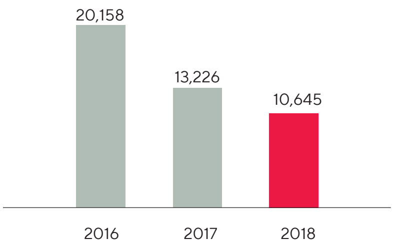
BBB+/A-2
Stable outlook

ROE reg. operations CET1 16%**

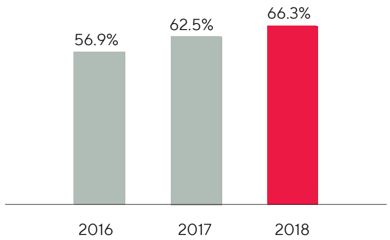


Profit after tax

(ISKm)

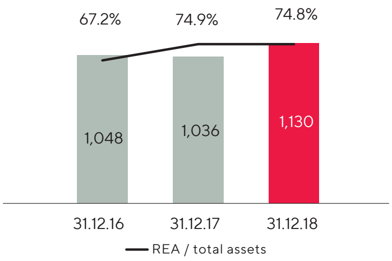


Cost / income ratio



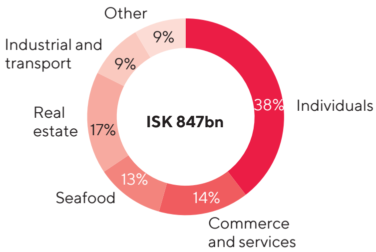
Total assets

(ISKbn)



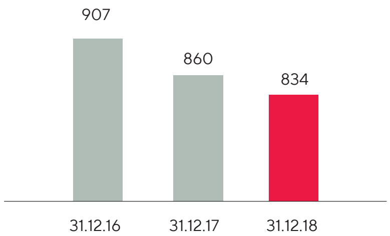
Loans to customers

(Sector split as at 31.12.18)



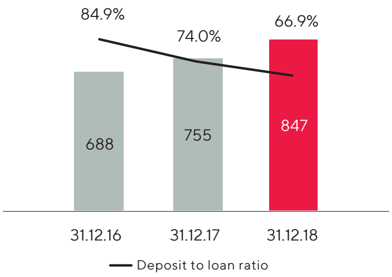
Number of FTE's for Parent Company

(Excluding seasonal employees)

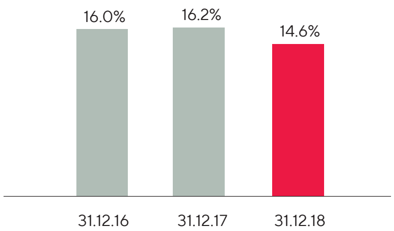


Loans to customers

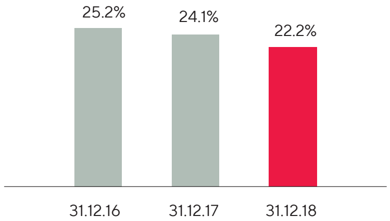
(ISKbn)



Leverage ratio



Total capital ratio



The information above has not been reviewed or audited by the Bank´s auditor.

*Based on Gallup survey regarding primary bank.
**Earnings on regular income now includes profit from discontinued operations. The Bank has introduced a new long term minimum capital target of 16% (CET1 16%), resulting in adjustments to its ROE on regular operations from previous levels (CET1 15%).

Directors' Report

The audited consolidated financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") for the financial year 2018 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as "the Group".

Operations in 2018

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share. The vision is to make Íslandsbanki #1 for service and for six years in a row our customers have been the most satisfied in the country, according to the Icelandic Customer Satisfaction Index.

The profit from the Group's operations for the reporting period amounted to ISK 10,645 million, which corresponds to 6.1% return on equity. The Board of Directors proposes that ISK 5.3 billion will be paid in dividends to shareholders. The Board may convene a special shareholders' meeting later in the year to propose payment of additional dividends if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements. In 2018, the Bank paid ISK 13 billion in dividends to the Bank's shareholders. At the end of the reporting period, the Group employed 1,075 full-time members of staff, including 834 within the Bank itself, 62% female and 38% male.

Net interest income increased by 6.5% between years, as strong balance sheet growth was somewhat offset by a lower interest rate environment. Net fee and commission income dropped by 11.1%, where growth in the Bank was offset by reduced activity in two of the subsidiaries of the Bank. Other net operating income was ISK 823 million, being positively impacted by the sale of one of the Bank's subsidiaries, while net financial income was negative by ISK 962 million, due to losses in mark-to-market of derivative hedges and losses on equity trading. Administrative expenses were up by 2.5% between years. Salary costs were up by 1.8% between years, as a result of reduced capitalisation of salaries in 2018, due to an investment in the Bank's core banking systems, and collective wage increases, somewhat offset by a reduction in full time equivalents' (FTE's) in the Bank. Net impairments were positive by ISK 1,584 million as the loan book continued to perform well on the back of a strong economy and a release of a provision as the statue of limitation for some disputed foreign currency-linked loan contracts passed.

The balance sheet of the Group grew by 9.1% between years on the back of a 12.1% growth in loans to customers. Loan book growth was especially strong in the first half of the year and slowed somewhat down in the second half and especially in the fourth quarter. Using the European Banking Authority's definition of non performing loans (NPL's), which does not only include loans to customers but also loans and advances to central banks and credit institutions, the Bank's NPL ratio was 1.7% at the end of 2018, compared to 3.4% average for European banks. The average LTV for mortgages decreased from 63% to 61%. Deposits from customers increased by 2.1% during the course of 2018, where an increase in deposits from individuals and SMEs was offset by a reduction in deposits from large corporates. The Bank's funding cost levels in the international capital markets deteriorated during 2018, as global market volatility increased and investors became more risk adverse. The Bank was however successful in its capital market funding operations, with issuance in line with the Bank's plans and a well received Tier 2 bond issuance in the third quarter of the year. The Bank's ratings were affirmed by both S&P (BBB+) and Fitch (BBB) with a stable outlook.

The Group's total equity amounted to ISK 176.3 billion and total assets were ISK 1,130.4 billion at the end of the reporting period and the Group's total capital ratio was 22.2%. At the end of September, the Group was presented with the results of the annual SREP process conducted by the Icelandic Financial Supervisory Authority. The results included the updated capital requirement for the Group. The total regulatory capital requirement is now 18.8% of the risk exposure amount, down from 19.8% the year before. The decrease in the capital requirement is due to a reduction in the Group's market risk profile. However, the Icelandic Financial Stability Council announced in May that the countercyclical buffer will increase by 50 basis points, from 1.25% to 1.75%, as of May 2019, which will then bring the total regulatory capital requirement up to 19.3%. Based on the updated SREP results, the Board of the Bank approved an updated capital target. The new target entails a management buffer of 0.5-2.0% on top of the SREP requirement, where the upper limit has been raised from 1.5% to provide management with more flexibility in its capital management. The updated overall capital target is therefore 19.3-20.8%, from the previous target of 20.3-21.3%, and will become 19.8-21.3% with the higher countercyclical buffer from May 2019 onwards. The Bank's liquidity position remains strong and well above regulatory requirements.

The Bank made considerable changes to its organisational structure in the second quarter of 2017. Three income-generating divisions now serve customers: Personal Banking, Business Banking, and Corporate & Investment Banking. These changes are now represented in these financial statements, as can be seen in Note 5.

In September, the Bank launched its new core banking system for deposits and payments. This is a major milestone operationally, as this has been the Bank's largest infrastructure project in recent times. Overall, the implementation was successful, with limited negative impact on the Bank's customers. The Bank also introduced several new digital solutions for its customers during the year, including a safe online live chat service, the first of its kind in Iceland and offered the option to use mobile phones and smart watches to pay for goods and services.

Directors' Report

Outlook

After seeing a very strong growth in recent years, the Bank's Chief economist is expecting 1.1% growth in 2019 and 3.1% in 2020. Investment levels are expected to remain close to 20% of GDP, where increased new construction of residential housing will offset a reduction in business investments. Consumer confidence has dropped considerably in recent quarters, after having peaked in 2016, and private consumption is therefore expected to show slow growth in the near term. Inflation was measured at 3.7% in 2018 and is expected to be a similar levels in 2019 and then coming down to 3.2% in 2020. At the same time, the current account surplus is expected to be around 3% of GDP in 2019, a similar level as was seen in 2018, and Iceland's net investment position and the Central Bank's foreign reserves are at very healthy levels.

The Bank remains in a very strong position, with a robust balance sheet and very healthy capital and liquidity levels in both the domestic krona and foreign currencies. Profitability has come down from the very high levels seen in recent years and achieving the 8-10% target ROE range will be a key challenge going forward. As economic growth recedes, growth in the loan book growth is expected to moderate, requiring stronger management focus to enhance profitability. The Bank will continue to invest in its IT infrastructure and digital solutions and thereby meet new requirements in the regulatory environment and enhance the customer experience.

Risk management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations and the Bank has focused on building up a responsible internal risk culture among the Bank's employees. 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 and the CEO is responsible for ensuring that risks are managed within those limits.

The Bank's risk management framework and policies are discussed under Notes 47-69 to the consolidated financial statements and in the unaudited Pillar 3 Report.

Ownership

Íslandsbanki is, and was during the year 2018, fully owned by the Icelandic State Treasury, directly (99.9%) and through its subsidiary ISB Holding ehf. (0.1%). The shares are administered by the Icelandic State Financial Investments (ISFI – Bankasýsla ríkisins) on its behalf.

Corporate governance

The Board of Directors of Íslandsbanki is committed to excellence in its governance framework so that it complies with the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as “Exemplary in Corporate Governance” in March 2014 by the Center of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in 2015, 2016, 2017 and 2018.

The Board of Directors comprises seven non-executive directors and two alternates. The Board undertakes the Bank's affairs and is responsible for setting the Bank's general strategy as well as instructing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with relevant laws, regulations and good business practices. Furthermore, the Board shall monitor the execution of its policies, the sound control of accounting and financial management, and ensure that group internal audit, compliance, risk management and internal controls are effective at all times.

Candidates for board membership are nominated through a selection process administered by the Icelandic State Financial Investments (ISFI) in accordance with Article 7 of the ISFI Act no. 88/2009. At the Bank's Annual General Meeting in March the Board of Directors was elected for the Bank. No changes were made to the Board members. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board consists of seven members, four female and three male. The Board has approved a policy on the suitability of the Board of Directors, the CEO and key function holders. The policy states, among other things, that the composition of the Board shall at any time be diversed, with regard to educational and professional background, gender and age.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of Board subcommittees are available on the Bank's website.

Directors' Report

The CEO is responsible for the day-to-day operations of the Bank and that the Bank's business is, at all times, in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Committee and other Senior Management Committees.

The Executive Committee, comprising seven members, including the CEO, is composed of four women and three men. The role of the Executive Committee is to maintain an overall view of the Bank's operations and to coordinate key aspects of its activities that are not supervised by other senior management committees. The CEO ensures that the Board is regularly provided with accurate information on the Bank's finances, development and operations.

The Bank's Finance division is responsible for the preparation of the Bank's consolidated financial statements in line with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review the second quarter interim consolidated financial statements and audit annual consolidated financial statements.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to its operations, including those imposed by the FME, Central Bank of Iceland and Nasdaq Iceland. The applicable laws include, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Public Limited Companies no. 2/1995 and the Act on Competition no. 44/2005, available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is (hereinafter the Guidelines). The Bank's practices are compliant with the guidelines except for Article 1.5.

Article 1.5 of the Guidelines provides that the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by ISFI in accordance with article 7 of the ISFI Act.

A more detailed description of Íslandsbanki's governance framework and associated practices can be found in the Bank's Corporate Governance Statement enclosed in an unaudited Appendix to the consolidated financial statements and on the Bank's website, www.islandsbanki.is.

Corporate social responsibility

Íslandsbanki adheres to a policy on corporate social responsibility with the aim to have a positive effect on society. Since 2010 Íslandsbanki has adhered to the UN Global Compact on social responsibility and annually publishes a social responsibility report on corporate social responsibility based on the UN Global Compact. The social responsibility report examines the policy and progress of projects that relate to corporate social responsibility.

As a signatory to the UN Global compact Íslandsbanki is committed to aligning its operations and strategies with 10 principles covering human rights, labour, the environment and anti-corruption. The Bank has in place a Code of Conduct and a Conflict of Interest Policy in order to ensure creditability in business transacted by the Bank and its clients and employees' impartiality in handling and processing individual cases.

Íslandsbanki supports the international relief work by the Red Cross by participating in the *Digital Divide Initiative* where the Red Cross and the Red Crescent work in more than ten African countries to improve knowledge and equipment in information technology. Íslandsbanki supports the initiative by providing both specialists in information technology to act as ambassadors as well as providing funds. Íslandsbanki's employees have already been on several diplomatic trips to Africa.

Last year Íslandsbanki joined the Nordic CEOs for a Sustainable Future, a group of some of the Nordic region’s largest listed companies that have committed to work together to speed up the realisation of the United Nation's Sustainable Development Goals (SDGs). Among the group are the CEOs of Equinor, Hydro, GSMA, Íslandsbanki, Nokia, SAS, Swedbank, Telenor Group, Telia Company, Vestas and Yara International. The CEOs have a common commitment to speak for the need for new business models to drive sustainable development.

For the fourth consecutive year Íslandsbanki held an equality meeting on the development of the gender ratio in different sectors. More than two thousand people have attended Íslandsbanki's meetings on gender equality and even more have watched them online.

Directors' Report

In the wake of the #metoo debate the Bank made a decision to go over all processes in place and make sure that members of staff knew how to report gender discrimination. The CEO and the executive directors met with about 150 members of staff in small group settings where the #metoo topic was discussed openly.

The Bank's social responsibility efforts are further described in the unaudited Annual Report.

Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2018 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable, to the extent that they are not inconsistent with the requirements of the IFRS as adopted by the EU.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2018 and its financial position as of 31 December 2018. The financial statements and the Director's report give fair view of the main operational developments and achievements and accurately describe the risks and uncertainties that the Group faces in its operations.

The Board of Directors and the CEO have today discussed and approved the 2018 Consolidated Financial Statements of Íslandsbanki.

Kópavogur, 13 February 2019

Board of Directors:

Friðrik Sophusson, Chairman
Helga Valfells, Vice-Chairman
Anna Þórðardóttir
Auður Finnbogadóttir
Árni Stefánsson
Hallgrímur Snorrason
Heiðrún Jónsdóttir

Chief Executive Officer:

Birna Einarsdóttir

Building a better working world

Independent Auditor's Report

To the Board of Directors and shareholders of Íslandsbanki hf.

Opinion

We have audited the consolidated financial statements of Íslandsbanki hf. and it subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2018 and the consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2018, and its consolidated financial performance and its consolidated cash flows for the year then ended, in accordance with the International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

Basis for Opinion

We conducted our audit in accordance with the International Standards on Auditing (ISAs). Our responsibilities are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) together with the ethical requirements that are relevant to our audit of the consolidated financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

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

Why significant	How our audit addressed the Key Audit Matter
Provision for credit impairment	

As described in Notes 2, 3 and 72.3, the provision for credit impairment is determined in accordance with International Financial Reporting Standard 9, Financial Instruments (IFRS 9). The new standard was implemented by the Group on 1 January 2018, replacing the former standard, IAS 39.
 	
IFRS 9 required considerable judgement and interpretation in its implementation. The new standard also introduced fundamental changes to the provision process, models and governance. The implementation of IFRS 9 and subsequent provisions for credit impairment was therefore considered a Key Audit Matter.
 	
Loans to customers represent ISK 846.599 million or 75% of total assets at 31 December 2018 against which impairment allowances of ISK 8.045 million have been recorded.
 	
Key areas of judgement included:
• the interpretation of the requirements to determine impairment under application of IFRS 9, which is reflected in the Group's expected credit loss model;
• the identification of loans with significant deterioration in credit quality;
• assumptions used in the expected credit loss model such as the financial condition of the counterparty, expected future cash flows and forward-looking macroeconomic factors as disclosed in Notes 2 and 72.3.
	Our audit procedures relating to the provision for credit impairment were conducted with the support of internal specialists. We assessed the IFRS 9 framework implemented by the Group, including the models developed and the inputs and assumptions applied. Our procedures focused on the following to respond to the Key Audit Matter, among others:
	
	• Assessed the Group's expected credit loss model, in particular focusing on the following areas:
	  ◦ alignment of the expected credit loss model and its underlying methodology with the requirements of IFRS 9; and
	  ◦ approach to the incorporation of forward-looking macroeconomic factors.
	• Tested the effectiveness of relevant controls relating, among others, to the:
	  ◦ data used to determine the provision for credit impairment, including transactional data captured at loan origination and ongoing internal credit quality assessment;
	  ◦ expected credit loss model, including model build and approval, ongoing monitoring/validation, model governance and mathematical accuracy;
	  ◦ registration and valuation of collateral used in the calculation of expected credit loss;
	• We examined a sample of loans and performed procedures to evaluate the:
	  ◦ timely identification of loans with significant deterioration in credit quality; and

- expected loss calculation by re-performing and assessing the reasonableness of the ECL model calculations.

In addition, we assessed the adequacy of the disclosures in the consolidated Financial Statements.

Why significant	How our audit addressed the Key Audit Matter
Reliability of information from IT systems	
The Group is highly dependent on IT systems due to the significant number of transactions that are processed daily and the complexity of the various systems used by the Group. As described in the Director´s Report on page 3, the Group also implemented a new deposits and payments system during the year. The implementation was on a large scale and affected various IT systems and processes within the Group increasing the risk of errors in data produced by the systems. In the process of preparing the consolidated Financial Statements the Group uses information from many systems and is dependent on the accuracy and completeness of information drawn from the systems. Because of the above we consider the accuracy and completeness of information generated by the IT systems a Key Audit Matter.	Our procedures focused on the following to respond to the Key Audit Matter, among others: • Using our internal IT specialists, we gained an understanding of the IT processes within the Group. • Based on that understanding and prior years' experience we selected the systems most important for the preparation of the consolidated Financial Statements. For those, we inspected the appropriateness of employees' access. • Recalculating interest income and expense calculations in the systems for selected dates during the year. • Comparing information from the systems with external data sources, such as currency exchange rates and consumer price index. • Recalculating reports generated by the systems. We performed specific procedures to address the implementation of the new system with a focus on the following, among others: • Gaining an understanding of the implementation process of the new system and discussing the implementation status and risks with management during the year. • Testing reconciliation of the new system and other systems at year end. • Inspecting reconciliation of the general ledger accounts used in the implementation and discussion about the process with employees responsible for the reconciliations. • Selecting a sample of transactions processed in the implementation and confirming our understanding and the nature of the transactions. • Assessed the work performed by the internal auditor in relation to the implementation. For a material outsourced system, we relied on an ISAE 3402 report provided by the service provider.

Other information in the Annual Report of Íslandsbanki hf. for the year 2018

Other information consists of the information included in Íslandsbanki´s 2018 Annual Report other than the consolidated financial statements and our auditor's report thereon. Management and Board of Directors are responsible for the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

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

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

The Chief Executive Officer (CEO) and Board of Directors are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institutions, where applicable.

The CEO and Board of Directors are responsible for such internal control that management determines is necessary to enable the preparation of the consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors is responsible for overseeing the Group's consolidated financial reporting process.

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

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

As part of an audit in accordance with the International Standards on Auditing (ISAs), we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion

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

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

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

Report on the Board of Directors report

Pursuant to the legal requirements of Article 104, Paragraph 2 of the Icelandic Financial Statement Act no. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the consolidated financial statements includes all information required by the Icelandic Financial Statement Act.

Reykjavík, 13 February 2019

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Margrét Pétursdóttir
State Authorised Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Consolidated Income Statement

	Notes	2018	2017
Interest income*		61,675	56,767
Interest expense		(29,738)	(26,768)
Net interest income	11	31,937	29,999
Fee and commission income		19,853	20,855
Fee and commission expense		(7,626)	(7,105)
Net fee and commission income	12	12,227	13,750
Net financial expense	13	(962)	(715)
Net foreign exchange gain	14	1	527
Other operating income	15	1,784	628
Other net operating income		823	440
Total operating income		44,987	44,189
Salaries and related expenses	16	(15,500)	(15,233)
Other operating expenses	17	(12,150)	(11,735)
Contribution to the Depositors' and Investors' Guarantee Fund		(1,173)	(1,083)
Bank tax	72.22	(3,281)	(2,892)
Total operating expenses		(32,104)	(30,943)
Profit before net impairment on financial assets		12,883	13,246
Net impairment on financial assets	19	1,584	1,556
Profit before tax		14,467	14,802
Income tax expense	20	(4,734)	(4,151)
Profit for the year from continuing operations		9,733	10,651
Profit from discontinued operations, net of income tax	21	912	2,575
Profit for the year		10,645	13,226

*Of which interest income amounting to ISK 59,741 million is calculated using the effective interest method.

	Notes	2018	2017
Profit attributable to:			
Shareholders of Íslandsbanki hf.		11,036	13,577
Non-controlling interests		(391)	(351)
Profit for the year		10,645	13,226
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	22	1.01	1.10

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 11 Amounts are in ISK million

Consolidated Statement of Comprehensive Income

	2018	2017
Profit for the year	10,645	13,226
Items that are or will be reclassified to profit or loss		
Foreign currency translation differences for foreign operations	-	9
Items that will not be reclassified to profit or loss		
Changes in fair value of financial assets and financial liabilities, net of tax	1,730	415
Other comprehensive income for the year, net of tax	1,730	424
Total comprehensive income for the year	12,375	13,650

Total comprehensive income attributable to:		
Shareholders of Íslandsbanki hf.	12,542	13,864
Non-controlling interests	(167)	(214)
Total comprehensive income for the year	12,375	13,650

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 12 Amounts are in ISK million

Consolidated Statement of Financial Position

	Notes	31.12.2018	31.12.2017
Assets			
Cash and balances with Central Bank	23	135,056	189,045
Bonds and debt instruments	6	69,415	27,090
Shares and equity instruments	6	13,074	10,177
Derivatives	24	4,550	2,896
Loans to credit institutions	25	41,577	26,617
Loans to customers	26	846,599	755,175
Investments in associates	28	682	704
Property and equipment	30	5,271	7,128
Intangible assets	31	5,002	4,231
Other assets	32	7,947	9,993
Non-current assets and disposal groups held for sale	33	1,230	2,766
Total Assets		1,130,403	1,035,822
Liabilities			
Deposits from Central Bank and credit institutions	34	15,619	11,189
Deposits from customers	35	578,959	567,029
Derivative instruments and short positions	24	5,521	5,492
Debt issued and other borrowed funds	37	300,976	217,748
Subordinated loans	38	16,216	9,505
Tax liabilities	40	7,150	7,787
Other liabilities	41	29,643	35,947
Non-current liabilities and disposal groups held for sale	33	6	80
Total Liabilities		954,090	854,777
Equity			
Share capital		10,000	10,000
Share premium		55,000	55,000
Reserves		6,499	6,179
Retained earnings		102,496	107,387
Total equity attributable to the equity holders of Íslandsbanki hf.		173,995	178,566
Non-controlling interests		2,318	2,479
Total Equity		176,313	181,045
Total Liabilities and Equity		1,130,403	1,035,822

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 13 Amounts are in ISK million

Consolidated Statement of Changes in Equity

	Share capital	Share premium	Restricted reserves	Fair value reserve	Liability credit reserve	Other reserves	Retained earnings	Total shareholders' equity	Non-controlling interests	Total equity
Equity as at 1.1.2017	10,000	55,000	1,673	(25)	-	2,491	105,563	174,702	4,223	178,925
Profit for the year							13,577	13,577	(351)	13,226
Dividends paid							(10,000)	(10,000)	(1,717)	(11,717)
Net change in fair value of AFS financial assets				264				264	151	415
Translation differences for foreign operations						9	14	23	(14)	9
Changes in non-controlling interests								-	187	187
Restricted due to capitalised development cost			1,312				(1,312)	-		-
Restricted due to fair value changes			266				(266)	-		-
Restricted due to subsidiaries and associates			189				(189)	-		-
Equity as at 31.12.2017	10,000	55,000	3,440	239	-	2,500	107,387	178,566	2,479	181,045
Impact of adopting IFRS 9, see Note 3					(1,486)		(2,530)	(4,016)	6	(4,010)
Impact of adopting IFRS 15, see Note 3							(97)	(97)		(97)
Equity as at 1.1.2018	10,000	55,000	3,440	239	(1,486)	2,500	104,760	174,453	2,485	176,938
Profit for the year							11,036	11,036	(391)	10,645
Dividends paid							(13,000)	(13,000)		(13,000)
Net change in fair value of financial assets				386				386	224	610
Net change in fair value of financial liabilities					1,110		10	1,120		1,120
Restricted due to capitalised development cost			458				(458)	-		-
Restricted due to fair value changes			123				(123)	-		-
Restricted due to subsidiaries and associates			(271)				271	-		-
Equity as at 31.12.2018	10,000	55,000	3,750	625	(376)	2,500	102,496	173,995	2,318	176,313

Authorised share capital of the Bank is 10,000 million ordinary shares of ISK 1 each. At 31.12.2018 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Bank. The Bank has one class of ordinary shares which carry no right to fixed income. The Annual General Meeting ("AGM") for the operating year 2017 was held on 22 March 2018. At the AGM shareholders approved the Board's proposal to pay dividends to shareholders amounting to ISK 13,000 million which is equivalent to ISK 1.30 per share (2017: ISK 1.00 per share). The dividends were paid on 28 March 2018.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 14 Amounts are in ISK million

Consolidated Statement of Cash Flows

	Notes	2018	2017
Profit for the year		10,645	13,226
Non-cash items included in profit for the year		16,061	10,766
Changes in operating assets and liabilities		(120,407)	(65,743)
Dividends received		55	41
Income tax and bank tax paid		(7,873)	(7,806)
Net cash used in operating activities		(101,519)	(49,516)
Net investment in subsidiaries and associated companies		4,764	(36)
Proceeds from sale of property and equipment		15	9
Purchase of property and equipment	30	(611)	(1,386)
Purchase of intangible assets	31	(877)	(1,803)
Net cash provided by (used in) investing activities		3,291	(3,216)
Proceeds from borrowings		115,661	56,287
Repayment of borrowings		(48,475)	(51,652)
Dividends paid		(13,000)	(2,449)
Dividends paid non-controlling interests		-	(2,148)
Net cash provided by financing activities		54,186	38
Net decrease in cash and cash equivalents		(44,042)	(52,694)
Effects of foreign exchange rate changes		(193)	(131)
Cash and cash equivalents at the beginning of the year		187,438	240,263
Cash and cash equivalents at year-end		143,203	187,438

Reconciliation of cash and cash equivalents			
Cash on hand	23	3,095	1,976
Cash balances with Central Bank	23	131,961	187,069
Bank accounts	25	25,259	15,959
Mandatory reserve and special restricted balances with Central Bank	23	(17,112)	(17,566)
Cash and cash equivalents at year-end		143,203	187,438

The Group has prepared its consolidated statement of cash flows 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.

Interest received in 2018 was ISK 58,354 million (2017: ISK 59,168 million) and interest paid in 2018 was ISK 24,386 million (2017: ISK 23,922 million). Interest paid is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 15 Amounts are in ISK million

Consolidated Statement of Cash Flows

	2018	2017
Depreciation and impairment	801	778
Amortisation of intangible assets	511	244
Share of gain of associates	(29)	(82)
Accrued interest and fair value changes on debt issued and subordinated loans	10,436	7,731
Net impairment on financial assets	(1,634)	(1,556)
Foreign exchange (gain)	(1)	(527)
Net gain on sale of subsidiary, property and equipment	(1,557)	(285)
Unrealised fair value loss (gain) recognised in profit or loss	406	(5)
Net profit on non-current assets classified as held for sale	(912)	(2,575)
Bank tax	3,281	2,892
Income tax	4,734	4,151
Other changes	25	-
Non-cash items included in profit for the year	16,061	10,766

	2018	2017
Mandatory reserve and special restricted balances with Central Bank	454	29,627
Loans to credit institutions	767	(5,613)
Loans to customers	(82,808)	(63,120)
Trading assets	(41,151)	(29)
Other operating assets	2,611	(2,811)
Non-current assets and liabilities held for sale	770	3,429
Deposits with credit institutions and Central Bank	4,116	6,095
Deposits from customers	4,307	(26,127)
Trading financial liabilities	(270)	(205)
Derivatives	(2,491)	(44)
Other operating liabilities	(6,712)	(6,945)
Changes in operating assets and liabilities	(120,407)	(65,743)

Non-cash transactions 2018

During the year the Bank repurchased own debt securities amounting to ISK 184 million by issuing new debt.

Non-cash transactions 2017

a) The Bank paid dividends amounting to ISK 10,000 million. Thereof are non-cash transactions amounting to ISK 7,551 million which were paid with a government bond.

b) The Bank's debt securities of ISK 12,083 million were paid during the period by issuing bonds. The transaction had no cash effect on the Group.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

Íslandsbanki hf. Consolidated Financial Statements 2018 16 Amounts are in ISK million

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. Corporate information

Íslandsbanki hf. the parent company was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The consolidated financial statements for the year ended 31 December 2018 comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

At the end of 2018 the Bank was wholly owned by the Icelandic Government, directly and through its subsidiary ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Group provides a wide range of financial services such as retail banking, corporate banking, investment banking, wealth management and asset financing. The Group operates mainly in the Icelandic market.

2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 13 February 2019.

On 1 January 2018 the Group implemented IFRS 9 - Financial Instruments and IFRS 15 - Revenue from Contracts with Customers. The impact of the implementation of IFRS 9 and IFRS 15 on the opening balance sheet at 1 January 2018 is disclosed in Note 3.

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, these consolidated financial statements have been prepared on a going concern basis.

These consolidated financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At year-end the exchange rate of the ISK against the USD was 116.33 and 133.23 for the EUR (2017: USD 104.42 and EUR 125.05).

Important accounting estimates and judgements

The preparation of the consolidated financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses recognised. Actual results may differ from those estimates.

Estimates and underlying assumptions are under constant review. Changes in accounting estimates are recognised when they occur.

Impairment of financial assets

Effective from 1 January 2018 the Group has applied IFRS 9 - Financial Instruments and the related amendments to the other IFRSs in accordance with the transition provisions set out in IFRS 9.
The main assumptions used for calculating the allowance for credit losses that are subject to significant judgement include the following:

• Probability of default (PD), loss given default (LGD) and exposure at default (EAD)
• Macroeconomic variables for multiple scenarios build on available information
• Assessment of significant increase in credit risk

The probability of default (PD), exposure at default (EAD), and loss given default (LGD) inputs used to estimate expected credit losses are modelled based on variables that are most closely related with credit losses in the relevant portfolio. This includes macroeconomic variables, demographic variables, variables related to past payment history among other variables. These variables are sourced both internally and externally.

The allowance for credit losses is further discussed in Notes 26-27, in Notes 50-52 on risk management and in Note 72.3.

Fair value of financial instruments

The fair value of financial instruments where an active market or quoted prices are not available are decided upon by using estimation procedures. The valuation methods are discussed in Notes 7-8 and in Note 72.3.

Intangible assets

Intangible assets, except for goodwill, are amortised over four to ten years. Intangible assets are reviewed at each reporting date to determine whether there is any indication of impairment. The value in use method is used by the Group to determine the recoverable amount of intangible assets. Intangible assets are further discussed in Note 31 and in Note 72.9.

Notes to the Consolidated Financial Statements

3. Changes to accounting policies

The new IFRS standards and amendments to standards which became effective from 1 January 2018 did not have a material impact on the Group's consolidated financial statements, except for changes to IFRS 9. Those changes are described below.

IFRS 9 – Financial Instruments

The Group adopted a new IFRS standard, IFRS 9 – Financial Instruments, which replaced IAS 39 as of 1 January 2018. As a result of the application of IFRS 9, the Group changed its accounting policies. The most significant changes were made to the accounting of impairment, classification and measurement of financial assets and financial liabilities. These new accounting policies were applicable from 1 January 2018 and are described in Note 72.3. Adjustments to carrying amounts of financial assets and financial liabilities at the date of initial application were recognised in equity as of 1 January 2018.

As permitted by the transition provisions of IFRS 9, the Group elected not to restate comparative period information; accordingly, all comparative period information is presented in accordance with previous accounting policies, as described in the Group's audited consolidated financial statements for the year ended 31 December 2017. New or amended disclosures have been provided for the current year, where applicable, and comparative period disclosures are consistent with those made in the prior year.

The Group has elected to continue to apply the hedge accounting principles under IAS 39 instead of those under IFRS 9. The policy for hedge accounting is described in Note 72.5.

Impact of adoption of IFRS 9

The IFRS 9 transition reduced shareholders' equity by ISK 4,010 million in total net of tax at 1 January 2018, thereof ISK 2,484 million is due to changes in impairments and ISK 1,526 million due to reclassification of debt securities. The CET1 capital ratio reduced by 25 basis points.

In addition to IFRS 9 the Group implemented IFRS 15 which does not have a material impact on the consolidated financial statements.

IFRS 15 – Revenue from Contracts with Customers

IFRS 15 – Revenue from contracts with customers became effective on 1 January 2018 and replaced various IFRS standards and interpretations on revenue recognition related to sale of goods and services. IFRS 15 establishes a single comprehensive framework for accounting for revenue arising from sale of goods and services through contracts which fall under its scope. IFRS 15 does not apply to revenue arising from financial instruments but it applies to fees charged by the Group which are not part of the effective interest rate of a financial instrument.

The Group adopted IFRS 15 by applying the cumulative effect method, under which the effect of initial adoption was recognised in equity on 1 January 2018 and comparative information was not restated. The Group recognised ISK 97.4 million as a decrease in retained earnings at 1 January 2018 due to the adoption of IFRS 15. This change is due to the change in revenue recognition for insurance broker commissions, whereas the transaction price now reflects a refund liability due to contractual provisions in the contract with the insurance provider, which is the principal in the transaction, and a related refund asset due to commissions paid by the Group to sale agents. Apart from this change the adoption of IFRS 15 did not result in changes to the timing or amount of revenue recognition.

As a result of the application of IFRS 15, the Group changed the presentation in the consolidated income statement as described in Note 71.

Notes to the Consolidated Financial Statements

3. Cont'd

Transition of financial assets and financial liabilities

The following table summarises the day one impact of the implementation of IFRS 9 showing the original measurement categories in accordance with IAS 39 and the new measurement categories under IFRS 9 for the Group's financial assets and financial liabilities.

At 1 January 2018	Classification IAS 39	Classification IFRS 9	Closing balance IAS 39	Reclassi-fication	Remeasure-ment	Opening balance IFRS 9
Cash and balances with Central Bank	Loans & receivables	Amortised cost	189,045	-	-	189,045
Listed bonds and debt instruments	Held for trading	Mandatorily at FVTPL	24,716	-	-	24,716
Listed bonds and debt instruments	Designated as at FVTPL*	Mandatorily at FVTPL	373	-	-	373
Unlisted bonds and debt instruments	Designated as at FVTPL*	Mandatorily at FVTPL	2,001	-	-	2,001
Listed shares and equity instruments	Held for trading	Mandatorily at FVTPL	5,108	-	-	5,108
Listed shares and equity instruments	Designated as at FVTPL	Mandatorily at FVTPL	1,645	-	-	1,645
Unlisted shares and equity instruments	Designated as at FVTPL	Mandatorily at FVTPL	2,188	-	-	2,188
Unlisted shares and equity instruments	Available for sale	Fair value through OCI	1,236	-	-	1,236
Derivatives	Held for trading	Mandatorily at FVTPL	2,891	5	-	2,896
Derivatives	Held for hedging	Held for hedging**	5	(5)	-	-
Loans to credit institutions	Loans & receivables	Amortised cost	26,617	-	(39)	26,578
Loans to customers	Loans & receivables	Amortised cost	755,175	-	(2,706)	752,469
Other financial assets	Loans & receivables	Amortised cost	9,847	-	(3)	9,844
Total financial assets			1,020,847	-	(2,748)	1,018,099
Deposits from CB and credit institutions	Amortised cost	Amortised cost	11,189	-	-	11,189
Deposits from customers	Amortised cost	Amortised cost	567,029	-	-	567,029
Derivative instruments and short positions	Held for trading	Mandatorily at FVTPL	5,071	421	-	5,492
Derivative instruments and short positions	Held for hedging	Held for hedging**	421	(421)	-	-
Debt issued and other borrowed funds	Designated as at FVTPL	Designated as at FVTPL***	-	82,655	1,908	84,563
Debt issued and other borrowed funds	Amortised cost	Amortised cost	217,748	(82,655)	-	135,093
Subordinated loans	Amortised cost	Amortised cost	9,505	-	-	9,505
Other financial liabilities	Amortised cost	Amortised cost	10,467	-	-	10,467
Total financial liabilities			821,430	-	1,908	823,338

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Notes to the Consolidated Financial Statements

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*At the date of initial application of IFRS 9 the Group reclassified certain bonds and debt instruments from designated as at FVTPL to mandatorily at FVTPL. These bonds and debt instruments are managed and evaluated on a fair value basis and are therefore to be mandatorily measured at fair value through profit or loss. No bonds and debt instruments are classified as designated at fair value through profit or loss or at fair value through OCI.

**IFRS 9 includes new hedge accounting rules, which align hedge accounting more closely with risk management. IFRS 9 includes an accounting policy choice to defer the adoption of IFRS 9 hedge accounting and to continue with IAS 39 hedge accounting. The Group has decided to exercise this accounting policy choice. On 1 January 2018 the Group discontinued applying hedge accounting for certain euro denominated debt securities and interest rate swaps.

***At the date of initial application of IFRS 9 the Group changed the classification of certain debt securities to being designated as at fair value through profit or loss. The impact of this change on 1 January 2018 was ISK 1,908 million (see Note 37).

Allowance for credit losses

The following table is a comparison of impairment allowances determined in accordance with IAS 39 and IAS 37 to the corresponding impairment allowance determined in accordance with IFRS 9 as at 1 January 2018.

	IAS 39				IFRS 9			
	Collectively assessed	Individually assessed	Total	Transition adjustments	Stage 1	Stage 2	Stage 3	Total
Loans at amortised cost*	1,729	8,662	10,391	2,745	2,741	1,244	9,151	13,136
Other assets at amortised cost	-	47	47	3	6	2	42	50
Off-balance sheet loan commitments and financial guarantees	-	64	64	610	467	101	106	674
Total allowance for credit losses	1,729	8,773	10,502	3,358	3,214	1,347	9,299	13,860

*Loans at amortised cost includes Loans to customers and Loans to credit institutions.

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Notes to the Consolidated Financial Statements

4. Changes to IFRS standards issued but not effective at the reporting date

A number of new IFRS standards and amendments to standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Changes that are likely to affect the Group's future financial reporting are described below, no significant impact is expected.

IFRS 16 – Leases

The Group adopted a new standard IFRS 16 – Leases, as of 1 January 2019. The new standard sets out the principles for the recognition, measurement, presentation and disclosure of leases and supersedes current leasing standards and interpretations within IFRS, such as IAS 17 – Leases. The standard removes the current requirement for lessees to classify leases as finance leases or operating leases by introducing a single lessee accounting model that requires the recognition of right-of-use assets and lease liabilities on the balance sheet. Lessees will be required to separately recognise the interest expense on the lease liability and the depreciation expense on the right-of-use asset in the income statement.

The Group applied IFRS 16 initially on 1 January 2019, using the modified retrospective approach and measuring the carrying amounts of right-of-use assets equal to lease liabilities at adoption.

The Group has completed an assessment, as a lessee, of the potential impact on its consolidated financial statements based on its operating leases and the economic conditions as at 31 December 2018. The Group will recognise new assets and liabilities for its leases of branches and office buildings. According to the results of the assessment, the carrying amount of the lease liabilities will be ISK 4,494 million, the same as the right-of-use assets.

The standard will only have insignificant changes to the accounting for lessors.

IFRS 9 – Financial Instruments, Prepayment Features with Negative Compensation

The Group adopted amendment to IFRS 9 – Financial Instruments , as of 1 January 2019 relating to the Solely payments of principal and interest (SPPI) test. With the amendment the word „additional" was deleted from the requirement of SPPI that a prepayment option will only be consistent with „Basic lending features" if the prepayment amount represents the principal amount outstanding plus accrued interest and may include a reasonable additional compensation for early termination. Before the amendment, the compensation for early termination could not be received by the party excercising the option. Subsequent to the amendment, a compensation that reflects changes in the relevant benchmark interest rate will be consistent with the SPPI test, regardless of whether the compensation is positive or negative. The SPPI test is described further in Note 72.3. The amendment will not have a significant impact on the Group's consolidated financial statements.

5. Operating segments

Segment information is presented in accordance with the Group's management and internal reporting structure.

The separation of Retail Banking into Personal Banking and Business Banking marks the final step towards implementing the Bank's organisational changes initiated and introduced in the second quarter of 2017. At the end of the year the Bank has three main business segments: Personal Banking, Business Banking and Corporate & Investment Banking.

Operating segments pay and receive interest to and from Treasury to reflect the allocation of capital, funding costs and the relevant risk premium.

The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market.

The Group comprises the following operating segments:

Personal Banking

Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments. Íslandsbanki's customers are increasingly taking care of their day-to-day banking via digital solutions such as apps, the online bank and the secure web chat. Customers can also visit the Bank's efficient branch network for comprehensive consultancy services.

Business Banking

Business Banking provides wide-ranging financial services to small- and medium-sized enterprises. Business Banking is organized around the branches where it can service its customers close to their own business. In addition, Business Banking operates Ergo, the asset based financing unit of the Bank.

5. Cont'd

Corporate & Investment Banking

Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors and affluent individuals. Services include customised products and services to customers including lending and advisory, risk management, brokerage and private banking services. The division is sector-focused, building and maintaining relationships with key customer segments within Iceland. Outside of Iceland, Íslandsbanki has a special focus on the North Atlantic seafood industry, leveraging its expertise in the domestic market and global contacts.

Treasury and Proprietary trading

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. It is also responsible for the Bank's balance sheet management and for the relations with investors, financial institutions, stock exchanges and rating agencies. Equity that is not allocated to business units sits within Treasury. Proprietary Trading includes equity and debt investments in the trading book and banking book.

Cost centres

Cost centres comprise the CEO’s office (Human Resources, Marketing & Communications, Strategy and Legal), Finance excluding Treasury and Proprietary Trading, Operations & IT, Risk Management and Compliance. Group Internal Audit is included in cost centres, however, it is independent from the Bank and the Chief Audit Executive reports directly to the Bank’s Board of Directors.

Subsidiaries, Eliminations and Adjustments

Subsidiaries include Borgun hf., Íslandssjóðir hf., Allianz Ísland hf. and other less significant subsidiaries (see Note 29).

Following is an overview showing the Group's performance with a breakdown by operating segments. Comparative amounts due to the organisational changes have not been restated.

Changes from prior periods include the additional line of income taxes, with breakdown for each segment according to the current tax rate and allocation of cost centres per segment within the Bank. Bank tax and contribution to the Icelandic Depositors’ and Investors’ Guarantee Fund are shown separately and allocated across segments. The allocation of Bank tax is based on the expected long-term ratio, as stated in the national budget. Furthermore, a line for depreciation and amortisation has been added.

Notes to the Consolidated Financial Statements

5. Cont'd

The year 2018	Personal Banking	Business Banking	Corporate & Investment Banking	Treasury & Proprietary Trading	Cost centres	The Bank total	Subsidiaries eliminations & adjustments	The Group total
Net interest income	9,946	9,788	7,676	3,649	(218)	30,841	1,096	31,937
Net fee and commission income	4,564	1,477	3,321	(109)	12	9,265	2,962	12,227
Other operating income	1	41	353	1,070	282	1,747	(924)	823
Total operating income	14,511	11,306	11,350	4,610	76	41,853	3,134	44,987
Salaries and related expenses	(2,585)	(2,069)	(1,641)	(258)	(6,185)	(12,738)	(2,762)	(15,500)
Other operating expenses	(2,466)	(1,062)	(680)	(494)	(5,646)	(10,348)	(1,802)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(669)	(395)	(109)	-	-	(1,173)	-	(1,173)
Bank tax	(434)	(327)	(470)	(2,041)	(9)	(3,281)	-	(3,281)
Net impairment on financial assets	579	955	164	(37)	-	1,661	(77)	1,584
Cost allocation	(5,134)	(2,813)	(2,660)	423	10,184	-	-	-
Profit (loss) before tax	3,802	5,595	5,954	2,203	(1,580)	15,974	(1,507)	14,467
Income tax expense	(989)	(1,455)	(1,548)	(1,280)	411	(4,861)	127	(4,734)
Profit (loss) for the year from continuing operations	2,813	4,140	4,406	923	(1,169)	11,113	(1,380)	9,733
Net segment revenue from external customers	14,958	14,996	17,337	(5,733)	295	41,853	3,134	44,987
Net segment revenue from other segments	(447)	(3,690)	(5,987)	10,343	(219)	-	-	-
Fee and commission income	5,990	1,612	3,420	133	12	11,167	8,686	19,853
Depreciation and amortisation	(275)	(142)	(26)	(38)	(688)	(1,169)	(143)	(1,312)
At 31 December 2018								
Loans to customers	299,429	219,608	322,974	904	-	842,915	3,684	846,599
Other assets	1,332	3,151	316	252,085	8,056	264,940	18,864	283,804
Total segment assets	300,761	222,759	323,290	252,989	8,056	1,107,855	22,548	1,130,403
Deposits from customers	275,265	164,738	101,417	42,566	-	583,986	(5,027)	578,959
Other liabilities	1,453	2,811	3,199	345,375	2,317	355,155	19,976	375,131
Total segment liabilities	276,718	167,549	104,616	387,941	2,317	939,141	14,949	954,090
Allocated equity	24,582	37,304	57,200	48,982	646	168,714	7,599	176,313
Risk exposure amount	164,795	239,073	360,923	61,986	3,316	830,093	15,856	845,949

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

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Notes to the Consolidated Financial Statements

5. Cont'd

Subsidiaries, eliminations & adjustments

The year 2018	Borgun hf.	Íslands-sjóðir hf.	Allianz Ísland hf.	Other subsidiaries	Eliminations & adjustments	Total
Net interest income	1,021	28	19	15	13	1,096
Net fee and commission income	1,104	1,028	950	(31)	(89)	2,962
Other operating income	3	21	13	519	(1,480)	(924)
Total operating income	2,128	1,077	983	503	(1,556)	3,134
Salaries and related expenses	(2,072)	(529)	(157)	-	(4)	(2,762)
Other operating expenses	(1,323)	(200)	(432)	(3)	156	(1,802)
Net impairment on financial assets	(76)	-	-	-	(1)	(77)
Profit (loss) before tax	(1,343)	348	394	499	(1,405)	(1,507)
Income tax expense	274	(74)	(79)	(1)	7	127
Profit (loss) for the year from cont. operations	(1,069)	274	315	498	(1,398)	(1,380)
Net segment revenue from external customers	2,813	1,217	939	1,125	(2,960)	3,134
Net segment revenue from other segments	(685)	(140)	44	(622)	1,403	-
Fee and commission income	9,331	1,421	950	-	(3,016)	8,686
Depreciation and amortisation	(141)	-	(3)	-	1	(143)
At 31 December 2018						
Total assets	28,498	2,466	1,043	9,352	(18,811)	22,548
Total liabilities	22,154	196	231	1,860	(9,492)	14,949
Total equity	6,344	2,270	812	7,492	(9,319)	7,599

The year 2017	Retail Banking	Corporate & Investment Banking	Treasury	Proprietary Trading & Subsidiaries	Cost centres & eliminations	Total
Net interest income	19,948	5,890	3,583	828	(250)	29,999
Net fee and commission income	6,018	3,165	(152)	4,699	20	13,750
Other operating income	20	260	(526)	4,562	(3,876)	440
Total operating income	25,986	9,315	2,905	10,089	(4,106)	44,189
Salaries and related expenses	(4,692)	(1,842)	(172)	(2,845)	(5,682)	(15,233)
Other operating expenses	(3,653)	(446)	(245)	(2,337)	(5,054)	(11,735)
Deposit Guarantee Fund	(1,059)	(12)	(10)	(2)	-	(1,083)
Bank tax	-	-	(2,892)	-	-	(2,892)
Net loan impairment	361	1,077	-	22	96	1,556
Cost allocation	(3,653)	(3,545)	422	(49)	6,825	-
Profit (loss) before tax	13,290	4,547	8	4,878	(7,921)	14,802
Income tax expense	(3,456)	(1,182)	612	(1,157)	1,032	(4,151)
Profit (loss) for the year from cont. operations	9,834	3,365	620	3,721	(6,889)	10,651
Net segment revenue from external customers	23,360	16,132	(2,377)	10,923	(3,849)	44,189
Net segment revenue from other segments	2,626	(6,817)	5,282	(834)	(257)	-
Depreciation and amortisation	(271)	(15)	(3)	(202)	(467)	(958)
At 31 December 2017						
Loans to customers	477,173	271,875	-	6,123	4	755,175
Other assets	3,676	1,038	222,690	58,435	(5,192)	280,647
Total segment assets	480,849	272,913	222,690	64,558	(5,188)	1,035,822
Deposits from customers	486,486	15,803	66,357	861	(2,478)	567,029
Other liabilities	6,906	2,099	249,695	27,262	1,786	287,748
Total segment liabilities	493,392	17,902	316,052	28,123	(692)	854,777
Allocated equity	59,078	45,272	63,497	22,498	(9,300)	181,045
Risk exposure amount	399,614	310,989	16,977	50,346	(2,434)	775,492

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6. Classification of financial assets and financial liabilities

At 31 December 2018

	Notes	Mandatorily at FVTPL	Held for hedging	Designated as at FVTPL	Fair value through OCI	Amortised cost	Carrying amount
Cash and balances with Central Bank	23	-	-	-	-	135,056	135,056
Listed bonds and debt instruments		67,901	-	-	-	-	67,901
Unlisted bonds and debt instruments		1,514	-	-	-	-	1,514
Listed shares and equity instruments		8,386	-	-	-	-	8,386
Unlisted shares and equity instruments		2,846	-	-	1,842	-	4,688
Derivatives	24	3,923	627	-	-	-	4,550
Loans to credit institutions	25	-	-	-	-	41,577	41,577
Loans to customers	26	-	-	-	-	846,599	846,599
Other financial assets		-	-	-	-	7,511	7,511
Total financial assets		84,570	627	-	1,842	1,030,743	1,117,782
Deposits from CB and credit institutions	34	-	-	-	-	15,619	15,619
Deposits from customers	35	-	-	-	-	578,959	578,959
Derivative instruments and short positions	24	5,521	-	-	-	-	5,521
Debt issued and other borrowed funds	37	-	40,714	68,154	-	192,108	300,976
Subordinated loans	38	-	-	-	-	16,216	16,216
Other financial liabilities		-	-	-	-	27,186	27,186
Total financial liabilities		5,521	40,714	68,154	-	830,088	944,477

At 31 December 2017

	Held for trading	Held for hedging	Designated as at FVTPL	Loans & receivables	Available for sale	Liabilities at amortised cost	Carrying amount
Cash and balances with Central Bank	-	-	-	189,045	-	-	189,045
Listed bonds and debt instruments	24,716	-	373	-	-	-	25,089
Unlisted bonds and debt instruments	-	-	2,001	-	-	-	2,001
Listed shares and equity instruments	5,108	-	1,645	-	-	-	6,753
Unlisted shares and equity instruments	-	-	2,188	-	1,236	-	3,424
Derivatives	2,891	5	-	-	-	-	2,896
Loans to credit institutions	-	-	-	26,617	-	-	26,617
Loans to customers	-	-	-	755,175	-	-	755,175
Other financial assets	-	-	-	9,847	-	-	9,847
Total financial assets	32,715	5	6,207	980,684	1,236	-	1,020,847
Deposits from CB and credit institutions	-	-	-	-	-	11,189	11,189
Deposits from customers	-	-	-	-	-	567,029	567,029
Derivative instruments and short positions	5,071	421	-	-	-	-	5,492
Debt issued and other borrowed funds	-	-	-	-	-	217,748	217,748
Subordinated loans	-	-	-	-	-	9,505	9,505
Other financial liabilities	-	-	-	-	-	10,467	10,467
Total financial liabilities	5,071	421	-	-	-	815,938	821,430

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7. Fair value information for financial instruments

Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Where a market price is not readily available, the Group applies valuation techniques based on estimates and assumptions that are consistent with that which market participants would use in setting a price for the financial instrument.

The table below shows financial instruments carried at fair value at 31 December 2018 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Valuation techniques based on observable inputs other than the quoted prices included in Level 1, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Valuation techniques based on significant unobservable inputs, e.g. internal assumptions.

At 31 December 2018

	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	67,901	-	1,514	69,415
Shares and equity instruments	8,344	42	4,688	13,074
Derivative instruments	-	4,550	-	4,550
Total financial assets	76,245	4,592	6,202	87,039
Derivative instruments	-	5,521	-	5,521
Debt issued and other borrowed funds designated as at FVTPL	68,154	-	-	68,154
Total financial liabilities	68,154	5,521	-	73,675

At 31 December 2017

	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	25,132	130	1,828	27,090
Shares and equity instruments	6,714	90	3,373	10,177
Derivative instruments	-	2,896	-	2,896
Total financial assets	31,846	3,116	5,201	40,163
Short positions	270	-	-	270
Derivative instruments	-	5,222	-	5,222
Total financial liabilities	270	5,222	-	5,492

Changes of Level 3 assets measured at fair value:	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2018	1,828	3,373
Purchases	8	790
Net loss on financial instruments recognised in profit or loss	(249)	(135)
Net gain on financial instruments recognised in other comprehensive income	-	610
Transfers from level 1 or 2	-	50
Other	(73)	-
Fair value at 31 December 2018	1,514	4,688

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Notes to the Consolidated Financial Statements

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	Bonds and debt instruments	Shares and equity instruments
Fair value at 1 January 2017	1,872	2,072
Purchases	13	578
Sales	(10)	(2)
Net (loss) gain on financial instruments recognised in profit or loss	(48)	126
Net gain on financial instruments recognised in other comprehensive income	-	417
Transfers from Level 1 or 2	-	206
Other	1	(24)
Fair value at 31 December 2017	1,828	3,373

The responsibility for the valuation of fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

At the end of each reporting period the Group determines whether transfers have occured between levels in the hierarchy, by reassessing categorisation based on the lowest level input that is significant to the fair value measurement as a whole.

Level 1: Fair value established from quoted market prices.

Level 1 financial assets and financial liabilities contain actively traded bonds and equities that are listed either domestically or abroad.

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

Level 2 assets and liabilities contain domestic bonds, equities as well as derivatives. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates.

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

Level 3 assets contain primarily unlisted and illiquid equities and bonds. Unlisted equities and bonds are initially recorded at their transaction price but are revalued each quarter based on the models as described above. At 31 December 2018 the Group's Level 3 equities amounted to ISK 4,688 million. These include shares in five professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,663 million. The Group receives information from fund managers which use valuation models for the valuation of these equities. Full access to information of all components in these valuation models is unavailable to the Group and therefore no basis for assumptions for sensitivity analysis.

The Group holds Series C preferred shares in Visa Inc., amounting to ISK 1,842 million, which are subject to selling restrictions for a period of up to 10 years and under certain conditions may have to be recalled. The fair value of the preferred shares is closely linked to the market value of Visa Inc. at NYSE stock exchange, written down by 30% due to uncertainty of the final number of shares and marketability.

For other level 3 equities, changes in components for valuation will have minimal impact on the Group's income statement.

The Group's Level 3 bonds amounted to ISK 1,514 million. The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on projected risk and financing cost.

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8. Financial instruments not carried at fair value

Assets

The fair value of "Loans to customers" may differ from their net carrying amount because the interest rates they carry may not reflect the interest rates that similar new loans would carry. The fair value is estimated by subtracting from or adding to the net carrying amount of the loans the discounted interest rate difference calculated from the reporting date until the next interest reset or maturity, whichever comes first. Since the interest rate difference is estimated using internal models these assets are classified as Level 3.

For "Cash and balances with Central Bank", "Loans to credit institutions" and "Other financial assets" the fair value is adequately approximated by the carrying amount as they are short-term in nature. They are thus classified as Level 2.

Liabilities

The fair value of a financial liability with a demand feature, such as a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. Most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. The fair value for longer term fixed rate deposits is calculated with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

Observed market value is used for the fair value of "Debt issued and other borrowed funds" where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin in the Group's issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions and liabilities to retailers for credit card provisions and they are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

The following tables show the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined in Note 7.

At 31 December 2018	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	135,056	-	135,056	135,056
Loans to credit institutions	-	41,577	-	41,577	41,577
Loans to customers	-	-	848,751	848,751	846,599
Other financial assets	-	7,511	-	7,511	7,511
Total financial assets	-	184,144	848,751	1,032,895	1,030,743
Deposits from Central Bank and credit institutions	-	15,633	-	15,633	15,619
Deposits from customers	-	579,232	-	579,232	578,959
Debt issued and other borrowed funds	151,767	84,476	-	236,243	232,822
Subordinated loans	16,167	-	-	16,167	16,216
Other financial liabilities	-	27,186	-	27,186	27,186
Total financial liabilities	167,934	706,527	-	874,461	870,802

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At 31 December 2017	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Cash and balances with Central Bank	-	189,045	-	189,045	189,045
Loans to credit institutions	-	26,617	-	26,617	26,617
Loans to customers	-	-	759,526	759,526	755,175
Other financial assets	-	9,847	-	9,847	9,847
Total financial assets	-	225,509	759,526	985,035	980,684
Deposits from Central Bank and credit institutions	-	11,192	-	11,192	11,189
Deposits from customers	-	567,235	-	567,235	567,029
Debt issued and other borrowed funds	119,819	104,482	-	224,301	217,748
Subordinated loans	9,457	-	-	9,457	9,505
Other financial liabilities	-	10,467	-	10,467	10,467
Total financial liabilities	129,276	693,376	-	822,652	815,938

9. Offsetting financial assets and financial liabilities

The tables below show reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

Financial assets	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2018	Financial assets before netting	Netting with financial liabilities	Net financial assets	Financial liabilities	Cash collateral received	Financial instruments collateral received	Net amount after consideration of potential effect of netting arrangements	Assets outside the scope of offsetting disclosure requirements	Total financial assets recognised in the balance sheet
Reverse repurchase agreements	153	-	153	-	-	-	153	-	153
Derivatives	4,550	-	4,550	(1,655)	(1,383)	(698)	814	-	4,550
Total assets	4,703	-	4,703	(1,655)	(1,383)	(698)	967	-	4,703
At 31 December 2017									
Reverse repurchase agreements	618	-	618	(270)	-	-	348	-	618
Derivatives	2,896	-	2,896	(733)	(1,482)	(9)	672	-	2,896
Total assets	3,514	-	3,514	(1,003)	(1,482)	(9)	1,020	-	3,514

Financial liabilities	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2018	Financial liabilities before netting	Netting with financial assets	Net financial liabilities	Financial assets	Cash collateral pledged	Financial instruments collateral pledged	Net amount after consideration of potential effect of netting arrangements	Liabilities outside the scope of offsetting disclosure requirements	Total financial liabilities recognised in the balance sheet
Derivative instruments and short positions	5,521	-	5,521	(1,655)	(85)	-	3,781	-	5,521
At 31 December 2017									
Derivative instruments and short positions	5,492	-	5,492	(733)	(492)	-	4,267	-	5,492

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10. Quarterly statements (unaudited)

2018	Q4	Q3	Q2	Q1	Total
Net interest income	8,294	8,301	7,602	7,740	31,937
Net fee and commission income	3,478	2,939	3,032	2,778	12,227
Net financial (expense) income	(637)	(420)	378	(283)	(962)
Net foreign exchange gain (loss)	76	(8)	(57)	(10)	1
Other operating income	120	64	1,587	13	1,784
Salaries and related expenses	(4,047)	(3,501)	(4,026)	(3,926)	(15,500)
Other operating expenses	(3,418)	(2,962)	(2,846)	(2,924)	(12,150)
Contribution to the Depositors' and Investors' Guarantee Fund	(299)	(295)	(287)	(292)	(1,173)
Bank tax	(740)	(944)	(812)	(785)	(3,281)
Net impairment on financial assets	(297)	(53)	1,846	88	1,584
Profit before tax	2,530	3,121	6,417	2,399	14,467
Income tax expense	(1,118)	(1,136)	(1,465)	(1,015)	(4,734)
Profit for the period from continuing operations	1,412	1,985	4,952	1,384	9,733
Profit from discontinued operations, net of income tax	(8)	126	81	713	912
Profit for the period	1,404	2,111	5,033	2,097	10,645

2017	Q4	Q3	Q2	Q1	Total
Net interest income	7,338	7,450	7,814	7,397	29,999
Net fee and commission income	3,632	3,305	3,543	3,270	13,750
Net financial income (expense)	260	(1,084)	97	12	(715)
Net foreign exchange gain	81	76	169	201	527
Other operating income	122	291	55	160	628
Salaries and related expenses	(4,297)	(3,168)	(4,109)	(3,659)	(15,233)
Other operating expenses	(3,358)	(2,879)	(2,739)	(2,759)	(11,735)
Contribution to the Depositors' and Investors' Guarantee Fund	(288)	(280)	(262)	(253)	(1,083)
Bank tax	(614)	(806)	(752)	(720)	(2,892)
Net loan impairment	969	147	200	240	1,556
Profit before tax	3,845	3,052	4,016	3,889	14,802
Income tax expense	(816)	(1,072)	(1,133)	(1,130)	(4,151)
Profit for the period from continuing operations	3,029	1,980	2,883	2,759	10,651
Profit from discontinued operations, net of income tax	83	93	2,114	285	2,575
Profit for the period	3,112	2,073	4,997	3,044	13,226

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11. Net interest income

	2018	2017
Cash and balances with Central Bank	7,279	10,541
Loans at amortised cost	52,462	45,162
Financial assets mandatorily at fair value through profit or loss	1,825	-
Financial assets designated as at fair value through profit or loss	-	50
Financial assets held for trading	-	879
Other assets	109	135
Total interest income	61,675	56,767
Deposits from credit institutions and Central Bank	(409)	(170)
Deposits from customers	(16,539)	(17,461)
Debt issued and other borrowed funds at fair value through profit or loss	(963)	-
Debt issued and other borrowed funds at amortised cost	(9,035)	(8,107)
Subordinated loans	(198)	(14)
Other financial liabilities	(2,565)	(995)
Other interest expense	(29)	(21)
Total interest expense	(29,738)	(26,768)
Net interest income	31,937	29,999
Interest margin (as the ratio of net interest income to the average carrying amount of total assets)	2.9%	2.9%

12. Net fee and commission income

	2018	2017
Asset management	2,116	1,964
Investment banking and brokerage	2,303	2,280
Payment processing	12,065	13,094
Loans and guarantees	1,467	1,427
Other fee and commission income	1,902	2,090
Total fee and commission income	19,853	20,855
Brokerage	(300)	(128)
Clearing and settlement	(7,302)	(6,956)
Other commission expenses	(24)	(21)
Total commission expenses	(7,626)	(7,105)
Net fee and commission income	12,227	13,750

Fee and commission income by segment is disclosed in Note 5.

13. Net financial expense

	2018	2017
Net loss on financial assets and liabilities held for trading	-	(1,239)
Net gain on financial assets designated as at fair value through profit or loss	-	480
Net loss on financial assets and liabilities mandatorily at FVTPL	(720)	-
Net loss on financial liabilities designated as at FVTPL	(240)	-
Net (loss) gain on fair value hedges	(2)	44
Net financial expense	(962)	(715)

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13. Cont'd

	2018	2017
Shares and related derivatives	(576)	-
Dividend income	38	-
Bonds and related derivatives	(197)	-
Other derivatives	15	-
Net loss on financial assets and liabilities mandatorily at FVTPL	(720)	-

	2018	2017
Debt issued and other borrowed funds designated as at FVTPL	(240)	-
Net loss on financial liabilities designated as at FVTPL	(240)	-

	2018	2017
Clean fair value gain (loss) on interest rate swaps designated as hedging instruments	486	(57)
Fair value (loss) gain on bonds issued by the Group attributable to interest rate risk	(488)	101
Net (loss) gain on fair value hedges	(2)	44

14. Net foreign exchange gain

	2018	2017
Cash and balances with Central Bank	(193)	(140)
Financial assets held for trading	-	2,503
Financial assets designated as at fair value through profit or loss	-	(93)
Financial assets mandatorily at fair value through profit or loss	2,281	-
Loans at amortised cost	17,120	2,062
Other assets	305	244
Net foreign exchange gain for assets	19,513	4,576
Deposits	(7,938)	859
Debt issued and other borrowed funds designated as at FVTPL	(3,868)	-
Debt issued and other borrowed funds at amortised cost	(6,567)	(4,613)
Subordinated loans	(884)	(241)
Other liabilities	(255)	(54)
Net foreign exchange loss for liabilities	(19,512)	(4,049)
Net foreign exchange gain	1	527

15. Other operating income

	2018	2017
Share of profit of associates, net of income tax	29	142
Net gain (loss) from sale of subsidiaries and associates*	1,526	(60)
Legal cost and fees	83	100
Rental income	37	38
Gain from sale of buildings	1	290
Other net operating income	108	118
Other operating income	1,784	628

*In the second quarter of 2018 the Group sold a subsidiary, which owned land in Reykjavík.

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Notes to the Consolidated Financial Statements

16. Personnel and salaries

	2018	2017
Salaries	11,923	12,212
Contributions to pension funds	1,767	1,734
Social security charges and financial activities tax*	1,723	1,758
Other	95	106
Capitalisation of internal staff costs in software development	(8)	(577)
Salaries and related expenses	15,500	15,233

*Financial activities tax calculated on salaries is 5.5% (2017: 5.5%).

The Group's total number of employees is as follows:	2018		2017	
	The Bank	The Group	The Bank	The Group
Average number of employees	873	1,076	915	1,098
Positions at the end of the year	834	1,075	861	1,042

Total amount of compensation to the Board of Directors, the CEO and Executive Board are specified as follows:

	2018	2017
Friðrik Sophusson, Chairman of the Board	11.3	10.6
Helga Valfells, Vice-Chairman of the Board	9.0	8.2
Anna Þórðardóttir, member of the Board	7.8	7.4
Auður Finnbogadóttir, member of the Board	7.5	7.0
Árni Stefánsson, member of the Board	7.5	7.0
Hallgrímur Snorrason, member of the Board	7.5	7.0
Heiðrún Jónsdóttir, member of the Board	7.7	7.0
Alternate board members	0.4	0.8
Total salaries	58.7	55.0

	2018		2017	
	Total salaries	Contri-butions to pension funds	Total salaries	Contri-butions to pension funds
Birna Einarsdóttir, CEO	63.5	14.0	58.0	11.6
Managing Directors	250.3	36.0	331.5	50.1
Total	313.8	50.0	389.5	61.7

The organisational changes in 2017 resulted in changes in the executive board, reducing the number of managing directors from eight to six. All expenses related to these changes were recognised in the income statement in 2017.

Benefits are non-monetary benefits such as the use of cars owned by the Group.

As of 1 January 2017, the Bank did not have a remuneration policy in place as stated in the Bank's compensation policy. In 2018 the Bank paid performance-based salaries which were earned in 2014. Included in total salaries are paid performance-based salaries for 2014. For the Bank's CEO those amounted to ISK 3.9 million (2017: ISK 9.7 million) and for the managing directors the payments amounted to ISK 12.5 million (2017: ISK 44.2 million). According to the Financial Supervisory Authority rules on variable remuneration, the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. If the employee gives a notice of termination, the employee shall no longer be entitled to the deferred payment. Unpaid performance, at year-end, based on salaries for 2015-2016 will be paid on the appropriate due dates in 2019 and 2020.

Contribution to pension funds for the Board of Directors amounted to ISK 7.2 million in 2018 (2017: ISK 6.3 million).

There were no share based payments in the years 2018 and 2017.

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Notes to the Consolidated Financial Statements

17. Other operating expenses

	2018	2017
Professional services	5,309	5,069
Real estate and fixtures	3,440	3,148
Depreciation and amortisation	1,312	1,022
Other administrative expenses	2,089	2,496
Other operating expenses	12,150	11,735

18. Auditors' fees

	2018	2017
Audit of the annual accounts	117	104
Review of interim accounts	24	22
Other services	15	11
Auditors' fees	156	137

19. Net impairment on financial assets

	2018	2017
Allowance for expected credit losses, on-balance sheet items	529	-
Allowance for expected credit losses, off-balance sheet items	38	-
Specific impairment	-	(2,478)
Collective impairment	-	317
Changes of provision due to court rulings	1,017	(737)
Impairment reversal due to revised estimated future cash flows	-	4,454
Net impairment on financial assets	1,584	1,556

20. Income tax expense

Income tax is recognised based on applicable tax rates and tax laws. The income tax rate for legal entities in 2018 is 20% (2017: 20%). Special financial activities tax is calculated as 6% of taxable profits exceeding ISK 1 billion in accordance with the Act on Financial Activities Tax no. 165/2011. The effective income tax rate in the Group's income statement for the year is 32.7% (2017: 28.0%).

	2018	2017
Current tax expense excluding discontinued operations	3,205	3,771
Special financial activities tax	860	832
Difference in prior year's imposed and calculated income tax	196	(53)
Changes in temporary differences due to deferred tax assets and deferred tax liabilities	473	(399)
Income tax recognised in the income statement	4,734	4,151

	2018	2017
Income tax due to the implementation of IFRS 9	(884)	-
Income tax due to equity activities	(884)	-

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20. Cont'd

	2018		2017	
Profit before tax	14,467		14,802	
20% income tax calculated on the profit of the year	2,893	20.0%	2,960	20.0%
Special financial activities tax	860	5.9%	832	5.6%
Expenses (income) not subject to tax	217	1.5%	(11)	(0.1%)
Non-deductible expenses	657	4.5%	584	3.9%
Other differences	107	0.8%	(214)	(1.4%)
Effective income tax expense	4,734	32.7%	4,151	28.0%

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

21. Profit from discontinued operations

	2018	2017
Net profit from sales of foreclosed mortgages	58	305
Net share of profit from disposal groups held for sale	854	360
Net profit from sale of subsidiaries	-	1,910
Profit from discontinued operations, net of income tax	912	2,575

22. Earnings per share

	Discontinued operations			
	Excluded		Included	
	2018	2017	2018	2017
Profit attributable to shareholders of the Bank	10,124	11,002	11,036	13,577
Weighted average number of outstanding shares	10,000	10,000	10,000	10,000
Basic earnings per share	1.01	1.10	1.10	1.36

The Group's basic and diluted earnings per share are equal as the Group has not issued any options, warrants, convertables, or other potential sources of dilution (2017: none).

23. Cash and balances with Central Bank

	31.12.2018	31.12.2017
Cash on hand	3,095	1,976
Balances with Central Bank	114,849	169,503
Balances with Central Bank assets subject to special restrictions*	3,049	4,593
Included in cash and cash equivalents	120,993	176,072
Mandatory reserve deposits with Central Bank**	14,063	12,973
Cash and balances with Central Bank	135,056	189,045

*Balances as defined in Act no. 37/2016 on the treatment of króna-denominated assets subject to special restrictions and rules no. 490/2016 on special reserve requirements for new foreign currency inflows.

**The Monetary Policy Committee of the Central Bank of Iceland has decided to change the arrangements for credit institutions' minimum reserve requirements so as to divide the reserve requirement into two parts: a fixed 1% reserve requirement bearing no interest, and a 1% reserve requirement of the type that has been in place, currently bearing 4% interest. The objective of these changes is to reduce the cost to the Central Bank in relation to foreign cash reserves. The new rules on minimum reserve requirements no. 585/2018 took effect on 21 June 2018.

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24. Derivative instruments and short positions

At 31 December 2018	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	1,037	102,429	3,422	134,010
Cross-currency interest rate swaps	1,821	69,691	1,184	28,309
Equity forwards	419	4,596	78	1,195
Foreign exchange forwards	359	9,242	196	3,869
Foreign exchange swaps	875	35,726	440	13,373
Bond forwards	39	3,511	201	19,993
Derivatives	4,550	225,195	5,521	200,749
Short positions in listed bonds	-	-	-	-
Total	4,550	225,195	5,521	200,749

At 31 December 2017	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	724	77,754	2,687	120,284
Cross-currency interest rate swaps	613	33,023	1,924	29,512
Equity forwards	217	1,669	99	1,846
Equity options	19	152	-	-
Foreign exchange forwards	211	7,263	117	5,992
Foreign exchange swaps	1,095	19,100	325	24,813
Bond forwards	17	2,444	70	7,430
Derivatives	2,896	141,405	5,222	189,877
Short positions in listed bonds	-	-	270	-
Total	2,896	141,405	5,492	189,877

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

Short positions are in Icelandic Government bonds and bonds issued by institutions with government guarantees. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain EUR denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate EUR denominated bonds (see Note 37) arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. The total fair value of the interest rate swaps at year-end 2018 was positive and amounted to ISK 627 million. Their total notional amount at year-end 2018 was ISK 39,696 million. At the beginning of 2018 the Group derecognised certain EUR denominated interest rate swaps as hedging instruments and classified them as mandatorily at fair value through profit and loss due to changes in classification of certain EUR denominated bonds. The notional amount of those interest rate swaps was ISK 62,525 million at year-end 2017.

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25. Loans to credit institutions

	31.12.2018	31.12.2017
Money market loans	16,314	10,658
Bank accounts	25,259	15,959
Other loans	4	-
Loans to credit institutions	41,577	26,617

26. Loans to customers

At 31 December 2018	Gross carrying amount			ECL allowance			Net carrying amount
	Stage 1	Stage 2	Stage 3	Stage 1	Stage 2	Stage 3	
Individuals	308,870	5,901	6,860	(1,130)	(256)	(855)	319,390
Commerce and services	118,563	4,981	3,358	(643)	(179)	(1,838)	124,242
Construction	25,958	3,301	298	(196)	(247)	(19)	29,095
Energy	6,145	740	-	(20)	(7)	-	6,858
Financial services	1,708	-	-	(4)	-	-	1,704
Industrial and transportation	74,338	2,625	3,800	(398)	(53)	(488)	79,824
Investment companies	18,709	5,128	398	(217)	(103)	(116)	23,799
Public sector and non-profit organisations	12,054	22	30	(18)	-	(1)	12,087
Real estate	139,073	2,588	2,087	(528)	(154)	(181)	142,885
Seafood	103,014	3,616	479	(123)	(80)	(191)	106,715
Loans to customers	808,432	28,902	17,310	(3,277)	(1,079)	(3,689)	846,599

At 31 December 2017	Gross amount	Specific impairment allowance	Loans less impairment allowance
Individuals	301,502	(2,152)	299,350
Commerce and services	115,128	(2,984)	112,144
Construction	25,816	(1,019)	24,797
Energy	7,109	-	7,109
Financial services	26	-	26
Industrial and transportation	71,258	(1,297)	69,961
Investment companies	20,138	(412)	19,726
Public sector and non-profit organisations	11,871	-	11,871
Real estate	127,323	(256)	127,067
Seafood	85,395	(542)	84,853
Loans to customers before collective impairment allowance	765,566	(8,662)	756,904
Collective impairment allowance			(1,729)
Loans to customers			755,175

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27. Expected credit loss

Loans to customers

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2018	2,701	1,244	9,151	13,096
Transfer to Stage 1	2,652	(1,733)	(919)	-
Transfer to Stage 2	(1,053)	2,317	(1,264)	-
Transfer to Stage 3	(99)	(1,167)	1,266	-
Net remeasurement of loss allowance	(2,073)	126	(429)	(2,376)
New financial assets originated or purchased	1,474	478	711	2,663
Derecognitions and maturities	(323)	(185)	(618)	(1,126)
Write-offs	(2)	(1)	(5,254)	(5,257)
Recoveries of amounts previously written off	-	-	416	416
Foreign exchange	-	-	87	87
Unwinding of interests	-	-	542	542
At 31 December 2018	3,277	1,079	3,689	8,045

Total expected credit loss

	Stage 1	Stage 2	Stage 3	Total
Cash and balances with Central Bank	48	-	-	48
Loans to credit institutions	62	-	-	62
Loans to customers	3,277	1,079	3,689	8,045
Other financial assets	5	3	83	91
Off-balance sheet loan commitments and financial guarantees	410	142	84	636
At 31 December 2018	3,802	1,224	3,856	8,882

Changes in the provision for impairment losses for loans to customers according to IAS 39:	Specific impairment allowance	Collective impairment allowance	Total
At 1 January 2017	11,472	2,049	13,521
Amounts written-off	(5,905)	(3)	(5,908)
Recoveries of amounts previously written-off	617	-	617
Charged to the income statement	2,478	(317)	2,161
At 31 December 2017	8,662	1,729	10,391

28. Investments in associates

	2018	2017
Investments in associates at the beginning of the year	704	450
Additions during the year	86	36
Sales of shares in associates	(39)	-
Transfer from associates to subsidiaries	(80)	-
Share of results	29	142
Dividends paid	(18)	(25)
Impairment	-	(60)
Other	-	161
Investments in associates	682	704

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28. Cont'd

The Group's interest in its associates are as follows:

		31.12.2018	31.12.2017
Auðkenni hf., an information security company, Borgartún 31, 105 Reykjavík	Iceland	23.8%	23.8%
JCC ehf., a cash centre service company, Borgartún 19, 105 Reykjavík	Iceland	33.3%	33.3%
Reiknistofa bankanna hf., an IT service centre company, Katrínartún 2, 105 Reykjavík	Iceland	30.8%	30.8%
B-Payment Szolgáltató Zrt., a payment processing company, H-1132 Budapest	Hungary	-	45.0%
FAST GP ehf., a holding company, Katrínartún 2, 105 Reykjavík	Iceland	-	35.0%
Summa Rekstrarfélag hf., an investment fund company, Tjarnargata 4, 101 Reykjavík	Iceland	-	25.0%

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

	2018	2017
Revenue	5,487	4,770
Profit	171	109
Assets	5,291	5,564
Liabilities	(2,932)	(3,280)
Net assets	2,359	2,284
Group's share of net assets of associates	682	704

29. Investments in subsidiaries

		31.12.2018	31.12.2017
Borgun hf., a payment acquirer and issuing processor, Ármúli 30, 108 Reykjavík	Iceland	63.5%	63.5%
B-Payment Group Szolgáltató Zrt., a payment processing company, H-1132 Budapest	Hungary	100%	-
Íslandssjóðir hf., an investment fund management company, Hagasmári 3, 201 Kópavogur	Iceland	100%	100%
Hringur-eignarhaldsfélag ehf., a holding company, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Dalshraun 3, 220 Hafnarfjörður	Iceland	100%	100%

During the third quarter the Group gained control over its associate B-Payment Szolgáltato Zrt. and its three subsidiaries, thereby making them subsidiaries of the Group.

In addition Íslandsbanki has control over 13 other non-significant subsidiaries.

Borgun hf. is the only significant subsidiary of Íslandsbanki that has a material non-controlling interest, 2018: 36.5% (2017: 36.5%).

The following table summarises key information relevant to Borgun hf.:

	2018	2017
Loans at amortised cost	7,425	8,652
Other assets	21,073	23,001
Liabilities	22,154	24,829
Net assets	6,344	6,824
Carrying amount of non-controlling interests	2,318	2,491
Revenue	10,383	15,110
(Loss) profit	(1,069)	350
Other comprehensive income for the year, net of tax	610	415
Total comprehensive income	(459)	765
Profit (loss) allocated to non-controlling interests	(167)	279
Cash flows from operating activities	(4,500)	(4,156)
Cash flows from investing activities	371	18
Cash flows from financing activities	19	(4,461)
Net decrease in cash and cash equivalents	(4,110)	(8,599)

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30. Property and equipment

At 31 December 2018 Historical cost	Land and buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	5,722	4,683	10,405
Additions during the year	15	829	844
Disposals and write-offs during the year	(1,683)	(1,528)	(3,211)
Total	4,054	3,984	8,038
Accumulated depreciation			
Balance at the beginning of the year	(1,330)	(1,947)	(3,277)
Depreciation during the year	(72)	(496)	(568)
Disposals and write-offs during the year	-	1,078	1,078
Total	(1,402)	(1,365)	(2,767)
Carrying amount	2,652	2,619	5,271
Depreciation rates	0-2%	8-33%	
Official real estate value of buildings and land			3,747
Insurance value of buildings			4,889
Insurance value of fixtures, equipment and vehicles			3,500

At 31 December 2017 Historical cost	Land and buildings	Fixtures, equipment & vehicles	Total
Balance at the beginning of the year	5,295	4,860	10,155
Additions during the year	107	1,279	1,386
Disposals and write-offs during the year	320	(1,456)	(1,136)
Total	5,722	4,683	10,405
Accumulated depreciation			
Balance at the beginning of the year	(1,256)	(2,688)	(3,944)
Depreciation during the year	(74)	(602)	(676)
Disposals and write-offs during the year	-	1,343	1,343
Total	(1,330)	(1,947)	(3,277)
Carrying amount	4,392	2,736	7,128
Depreciation rates	0-2%	8-33%	
Official real estate value of buildings and land			4,647
Insurance value of buildings			6,158
Insurance value of fixtures, equipment and vehicles			3,892

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31. Intangible assets

At 31 December 2018

Historical cost	Purchased software	Developed software	Goodwill	Total
Balance at the beginning of the year	1,381	3,090	-	4,471
Additions during the year and internal development	479	555	248	1,282
Disposals during the year	(221)	(1)	-	(222)
Total	1,639	3,644	248	5,531
Accumulated amortisation				
Balance at the beginning of the year	(39)	(201)	-	(240)
Amortisation during the year	(345)	(106)	-	(451)
Disposals during the year	162	-	-	162
Total	(222)	(307)	-	(529)
Carrying amount	1,417	3,337	248	5,002
Amortisation rates	10-25%	10-25%	-	

At 31 December 2017

Historical cost	Purchased software	Developed software	Total
Balance at the beginning of the year	1,598	1,774	3,372
Additions during the year and internal development	487	1,316	1,803
Disposals during the year	(704)	-	(704)
Total	1,381	3,090	4,471
Accumulated amortisation			
Balance at the beginning of the year	(499)	(201)	(700)
Amortisation during the year	(180)	-	(180)
Disposals during the year	640	-	640
Total	(39)	(201)	(240)
Carrying amount	1,342	2,889	4,231
Amortisation rates	25%	10-25%	

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32. Other assets

	31.12.2018	31.12.2017
Receivables	5,793	6,736
Unsettled securities transactions	1,033	2,620
Accruals	289	205
Prepaid expenses	395	215
Deferred tax assets	215	4
Other assets	222	213
Other assets	7,947	9,993

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

	31.12.2018	31.12.2017
Repossessed collateral	1,012	1,224
Assets of disposal groups classified as held for sale	218	1,542
Total	1,230	2,766

Land and property	995	1,194
Industrial equipment and vehicles	17	30
Repossessed collateral	1,012	1,224

At year-end 2018 the Group classified the assets and liabilities of the following subsidiaries as assets and liabilities of disposal groups held for sale: Fastengi ehf. (100%), ÍSB fasteignir ehf. (100%) and LT lóðir ehf. (100%).

Assets and liabilities of disposal groups classified as held for sale:

	31.12.2018	31.12.2017
Equity instruments	-	775
Receivables	-	484
Property and land	193	252
Other assets	25	31
Total assets	218	1,542
Payables	1	1
Tax liabilities	5	79
Total liabilities	6	80

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34. Deposits from Central Bank and credit institutions

	31.12.2018	31.12.2017
Repurchase agreements with Central Bank	92	92
Deposits from credit institutions	15,527	11,097
Deposits from Central Bank and credit institutions	15,619	11,189

35. Deposits from customers

	31.12.2018	31.12.2017
Demand deposits*	499,170	479,590
Time deposits	79,789	87,439
Deposits from customers	578,959	567,029

*Demand deposits include deposits with maturity of up to 3 months.

Deposits from customers specified by owners:

	31.12.2018		31.12.2017	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	9,331	2%	6,071	1%
Municipalities	5,574	1%	7,054	1%
Companies	278,209	48%	290,405	51%
Individuals	285,845	49%	263,499	47%
Deposits from customers	578,959	100%	567,029	100%

36. Pledged assets

	31.12.2018	31.12.2017
Financial assets pledged as collateral against liabilities	190,471	149,663
Financial assets pledged as collateral in foreign banks	1,105	908
Financial assets pledged as collateral in repurchase agreements	153	618
Pledged assets against liabilities	191,729	151,189

The Group has pledged assets against the issuance of covered bonds under Icelandic law, which are pledged on a pool of consumer mortgage loans. The underlying cover pool must withstand a weekly stress test.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk.

The comparative amount in the line item "Financial assets pledged as collateral against liabilities" at 31.12.2017 has been increased by ISK 4,800 million for comparison with 31.12.2018 to take into consideration assets pledged as collateral to the Central Bank of Iceland to secure settlement in the Icelandic cash clearing systems.

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37. Debt issued and other borrowed funds

	Issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
Covered bond in ISK*	2014-2017	2019	At maturity	Fixed rates	9,866	10,120
Covered bond in ISK	2015-2018	2023	At maturity	Fixed rates	10,890	7,469
Covered bond in ISK - CPI-linked	2012-2014	2019	At maturity	Fixed rates	8,937	8,666
Covered bond in ISK - CPI-linked	2014-2015	2020	At maturity	Fixed rates	4,248	4,117
Covered bond in ISK - CPI-linked	2015-2017	2022	At maturity	Fixed rates	18,009	17,467
Covered bond in ISK - CPI-linked	2012-2018	2024	At maturity	Fixed rates	35,009	21,963
Covered bond in ISK - CPI-linked	2015-2018	2026	At maturity	Fixed rates	26,992	24,049
Covered bond in ISK - CPI-linked	2017-2018	2030	At maturity	Fixed rates	24,862	15,089
Covered bonds					138,813	108,940
Senior unsecured bond in EUR**	2015-2016	2018	At maturity	Fixed rates	-	19,004
Senior unsecured bond in NOK	2015	2018	At maturity	Floating rates	-	6,391
Senior unsecured bond in SEK	2015	2019	At maturity	Floating rates	7,844	7,660
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	400	375
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	2,665	2,500
Senior unsecured bond in EUR	2017	2019	At maturity	Floating rates	1,333	1,253
Senior unsecured bond in EUR**	2016	2020	At maturity	Fixed rates	68,154	63,651
Senior unsecured bond in SEK	2018	2019	At maturity	Floating rates	1,302	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	1,303	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	1,311	-
Senior unsecured bond in SEK	2018	2022	At maturity	Floating rates	12,995	-
Senior unsecured bond in SEK	2018	2020	At maturity	Floating rates	3,259	-
Senior unsecured bond in SEK	2018	2021	At maturity	Floating rates	13,750	-
Senior unsecured bond in EUR***	2018	2024	At maturity	Fixed rates	40,714	-
Bonds issued					155,030	100,834
Bills issued					6,729	7,538
Other debt securities					404	436
Other borrowed funds					7,133	7,974
Debt issued and other borrowed funds					300,976	217,748

*Íslandsbanki repurchased own covered bonds during the year amounting to ISK 184 million.

**At the date of initial application of IFRS 9 the Group changed the classification of certain debt securities to being designated as at fair value through profit or loss. The impact of this change on 1.1.2018 amounted to ISK 1,908 million. At 31 December 2018 the total carrying amount of the bond issuance amounted to ISK 68,154 million and included in the amount are fair value changes amounting to ISK 401 million. The carrying amount of the debt securities designated as at fair value through profit or loss at 31 December 2018 was ISK 374 million higher than the contractual amount due at maturity.

***The Group applies hedge accounting to this bond issuance and uses certain EUR denominated interest rate swaps as hedging instruments (see Note 24). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate EUR denominated bond arising from changes in interest rates. The Group applies fair value hedge accounting to the hedging relationships. At 31 December 2018 the total carrying amount of the bond issuances amounted to ISK 40,714 million and included in the amount are fair value changes amounting to ISK 488 million.

The covered bond amounts do not contain the bonds reserved for securities lending.

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38. Subordinated loans

	Issued	Maturity	Maturity type	Terms of interest	31.12.2018	31.12.2017
Loans which qualify as Tier 2 capital:						
Subordinated loans in SEK	2017	2027	At maturity	Floating, STIBOR + 2.0%	9,724	9,505
Subordinated loans in SEK*	2018	2028	At maturity	Floating, STIBOR + 2.5%	6,492	-
Subordinated loans					16,216	9,505

*The Group issued an SEK 500 million Tier 2 bond in the third quarter of 2018.

39. Changes in liabilities arising from financing activities

	31.12.2017	Reclas & remeasure	1.1.2018	Cash flows	Non-cash changes			31.12.2018
					Interest expense	Foreign exchange movement	Fair value changes	
Covered bonds NIL	17,589	-	17,589	2,055	1,112	-	-	20,756
Covered bonds CPI	91,351	-	91,351	20,134	6,572	-	-	118,057
Senior unsecured bonds FX	37,182	(19,003)	18,179	23,275	531	4,177	-	46,162
Senior unsecured bonds FX at fair value ...	-	84,563	84,563	(20,083)	963	3,868	(1,157)	68,154
Senior unsecured bonds used for hedging	63,652	(63,652)	-	37,406	430	2,390	488	40,714
Short-term borrowings	7,974	-	7,974	(1,231)	390	-	-	7,133
Subordinated loans	9,505	-	9,505	5,629	198	884	-	16,216
Total	227,253	1,908	229,161	67,185	10,196	11,319	(669)	317,192

	1.1.2017	Cash flows	Non-cash changes				31.12.2017
			Interest expense	Foreign exchange movement	Fair value changes	Other	
Covered bonds NIL	15,491	1,031	1,067	-	-	-	17,589
Covered bonds CPI	48,733	27,170	3,365	-	-	12,083	91,351
Senior unsecured bonds FX	64,133	(30,854)	2,361	1,542	-	-	37,182
Other loans	17,207	(2,690)	-	-	-	(14,517)	-
Senior unsecured bonds used for hedging	61,125	(1,108)	665	3,071	(101)	-	63,652
Short-term borrowings	5,779	1,835	360	-	-	-	7,974
Subordinated loans	-	9,250	14	241	-	-	9,505
Total	212,468	4,634	7,832	4,854	(101)	(2,434)	227,253

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40. Tax assets and tax liabilities

	31.12.2018 Assets	31.12.2018 Liabilities	31.12.2017 Assets	31.12.2017 Liabilities
Current tax	-	6,472	-	7,699
Deferred tax	215	678	4	88
Tax in the balance sheet	215	7,150	4	7,787

Changes in the deferred tax assets and the tax liabilities during the year were as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2017	4	487
Calculated income tax for 2017	(47)	3,545
Income tax payable in 2018	47	(3,800)
Prior year's income tax adjustment	-	(144)
Deferred tax assets and tax liabilities 31.12.2017	4	88
Calculated income tax for 2018	211	3,888
Income tax payable in 2019	-	(3,214)
Income tax due to equity activities	-	(94)
Prior year's income tax adjustment	-	10
Deferred tax assets and tax liabilities 31.12.2018	215	678

Movements in temporary differences during the year were as follows:

2018	Net balance at 1 January	Recognised in profit or (loss)	Recognised in equity	Balance at 31 December Net	Balance at 31 December Deferred tax assets	Balance at 31 December Deferred tax liabilities
Property and equipment	(79)	(170)	-	(249)	-	(249)
Intangible assets	(395)	(132)	-	(527)	-	(527)
Assets and liabilities denominated in foreign currency	(186)	(78)	-	(264)	-	(264)
Deferred foreign exchange difference	(202)	(11)	-	(213)	-	(213)
Derivatives	465	(271)	-	194	194	-
Debt issued and other borrowed funds	314	(79)	94	329	329	-
Other items	(1)	(1)	-	(2)	-	(2)
Tax loss carry forwards	-	269	-	269	269	-
	(84)	(473)	94	(463)	792	(1,255)
Set-off of deferred tax assets together with liabilities of the same taxable entities					(577)	577
Tax assets (liabilities)	(84)	(473)	94	(463)	215	(678)

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2017	Net balance at 1 January	Recognised in profit or (loss)	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(147)	68	(79)	-	(79)
Intangible assets	(175)	(220)	(395)	-	(395)
Assets and liabilities denominated in foreign currency	(183)	(3)	(186)	-	(186)
Deferred foreign exchange difference	23	(225)	(202)	4	(206)
Derivatives	-	465	465	465	-
Debt issued and other borrowed funds	-	314	314	314	-
Other items	-	(1)	(1)	-	(1)
Tax loss carry forwards	(1)	1	-	-	-
	(483)	399	(84)	783	(867)
Set-off of deferred tax assets together with liabilities of the same taxable entities				(779)	779
Tax assets (liabilities)	(483)	399	(84)	4	(88)

41. Other liabilities

	31.12.2018	31.12.2017
Accruals	3,906	4,049
Liabilities to retailers for credit cards	20,722	23,878
Provision for effects of court rulings	-	1,811
Off-balance sheet loan commitments and financial guarantees	636	64
Withholding tax	1,733	1,596
Unsettled securities transactions	612	1,384
Deferred income	193	199
Sundry liabilities	1,841	2,966
Other liabilities	29,643	35,947

Reconciliation of off-balance sheet loan commitments and financial guarantees:

	Stage 1	Stage 2	Stage 3	Total
At 1 January 2018	467	101	106	674
Transfer to Stage 1	595	(545)	(50)	-
Transfer to Stage 2	(58)	67	(9)	-
Transfer to Stage 3	(6)	(69)	75	-
Net remeasurement of loss allowance	(828)	481	(132)	(479)
New loan commitments and financial guarantees	521	130	132	783
Derecognitions and maturities	(281)	(23)	(38)	(342)
At 31 December 2018	410	142	84	636

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42. Custody assets

	31.12.2018	31.12.2017
Custody assets - not managed by the Group	2,167,946	2,101,434

43. Leases

Future non-cancellable minimum operating lease payments, where the Group is lessee:

	31.12.2018	31.12.2017
Due within 1 year	470	438
Due in 1-5 years	1,831	1,752
Due in more than 5 years	2,842	3,430
Operating lease commitments	5,143	5,620

The Group has lease agreements in place for its headquarters and some of the branches. A typical lease agreement is CPI-linked with a duration of 5-10 years and has an extension clause.

In 2018 the Group paid ISK 492 million for the operating leases (2017: ISK 437 million).

Net investment in finance lease receivables, where the Group is lessor:

	31.12.2018	31.12.2017
Due within 1 year	18,524	14,398
Due in 1-5 years	30,195	29,916
Due in more than 5 years	3,011	3,301
Total gross investment in the lease	51,730	47,615
Due within 1 year	16,069	12,031
Due in 1-5 years	26,730	26,219
Due in more than 5 years	2,317	2,515
Total present value of lease payments	45,116	40,765
Unearned financial income	6,614	6,850
Accumulated loan-loss provision	193	187
Variable lease payments recognised as income during the year	3,166	2,999

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44. Related party

Íslandsbanki is wholly owned by the Icelandic Government, directly and through ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments (ISFI). As a result, the Icelandic Government and the Icelandic State Financial Investments are defined as related parties. The Group has applied the partial exemption for government-related entities, as described in IAS 24, and does not disclose those transactions in the related party note.

The Board of Directors and key management personnel of the Bank, ISFI, ISB Holding ehf. and subsidiaries of the Bank, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates are also defined as related parties.

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner, the Bank and other Group entities purchase products and services from government-related entities under generally accepted commercial terms. Transactions with related parties were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third party counterparties.

Cash and balances with the Central Bank are disclosed under Note 23 and Deposits from the Central Bank are disclosed under Note 34.

All loans to employees are provided on general business terms of the Group and the balances do not reflect collaterals held by the Group.

At 31 December 2018	Assets	Liabilities	Net balance	Commitments & overdrafts
Shareholders with control over the Group	-	105	(105)	-
Board of Directors, key management personnel and other related parties	220	493	(273)	82
Associated companies	198	469	(271)	210
Balances with related parties	418	1,067	(649)	292

1 January - 31 December 2018	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	2	-	-
Board of Directors and key management personnel	16	10	2	-
Associated companies	15	10	2	1,937
Transactions with related parties	31	22	4	1,937

At 31 December 2017	Assets	Liabilities	Net balance	Commitments & overdrafts
Shareholders with control over the Group	-	103	(103)	1
Board of Directors and key management personnel	287	415	(128)	59
Associated companies and other related parties	330	743	(413)	232
Balances with related parties	617	1,261	(644)	292

1 January - 31 December 2017	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	3	-	-
Board of Directors and key management personnel	16	13	-	-
Associated companies and other related parties	24	25	2	1,801
Transactions with related parties	40	41	2	1,801

At year-end 2018 ISK 2 million were recognised as Stage 1 expected credit loss against balances outstanding with related parties (2017: none). No share option programmes were operated during the reporting period 1 January - 31 December. For related party renumeration see Note 16.

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45. Contingencies

Provisions

Variable rate loan contracts

The Consumer Agency concluded in 2014 that previous mortgage loan interest reset terms offered by the Group and its predecessors in the years between 2004-2011 did not fulfil the requirements of the law on consumer loans. The Supreme Court found in favour of the Consumer Agency in October 2017. Close to 1,600 customers were affected. The Group had early on recognised a provision of ISK 800 million against the loss due to this ruling. This provision proved to be sufficient and repayments to customers have been completed.

Contingent liabilities

Borgun hf.

Borgun hf., a subsidiary of Íslandsbanki, is a payment acquirer and issuing processor. Landsbankinn hf. sold its 31.2% stake in Borgun in late 2014. Landsbankinn claims that Borgun's management did not release all available information that might have affected the value of Borgun during the sales process, namely the worth of its stake in Visa Europe which was sold to Visa International shortly after the Borgun sale. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit on 12 January 2017, claiming the right to damages for having been deprived of the true value of the stake involved in the sale. The plaintiff does not quantify the claim, but his estimate of the loss of profit is approximately ISK 1,930 million (by selling the shares in Borgun). Seeing that the conclusion of the case is uncertain and the financial effect cannot be estimated, the Group has not recognised a provision in relation to this matter. The court has appointed professionals to assess the claim but it is uncertain when the assessment will be completed. Therefore it is uncertain when a ruling is to be expected.

Kortaþjónustan hf.

Kortaþjónustan hf., a payment acquirer, filed a suit against Íslandsbanki hf., Arion banki hf., Landsbankinn hf., Borgun hf., and Valitor hf. in June 2013. The plaintiff asked for damages in the amount of ISK 1,191 million, plus interest, mainly due to alleged infringements of competition law. Later claims amount to ISK 923 million plus interest, collectively. The case has been dismissed two times by the courts on technical grounds. The plaintiff filed the case for the third time last November. The Group has not recognised a provision in relation to this matter.

Contingent assets

Settlement of the 2011 Byr acquisition

The Group acquired Byr hf. ("Byr"), a former savings bank, in 2011, 88.4% from Byr Sparisjóður and 11.6% from the Icelandic Ministry of Finance and Economic Affairs ("Ministry"). In June 2013 the Group filed a priority claim with the winding-up board of Byr, sparisjóður. The winding-up board rejected the Group’s claim and referred the dispute to the District Court of Reykjavík. Subsequently the Group made a formal claim with the Ministry that has also been submitted to the District Court of Reykjavík. The District Court of Reykjavík confirmed the Composition Agreement of Byr Savings Bank on 8 January 2016. At the same time the name of Byr, sparisjóður was changed to Old Byr. In February 2019 Íslandsbanki and Old Byr reached an agreement on the settlement of the dispute, that entails a payment to the Group in the amount of ISK 975 million, payable by mid-April 2019 and that upon the payment the parties agree to dismiss the case. Simultaneously, Old Byr will make a distribution to the Group, in accordance with the bonds issued to creditors as part of the composition of Old Byr. We anticipate that an equitable settlement will be reached with the Ministry on the dismissal of that case. The Group has not recognised any revenues relating to these claims, see Note 46.

46. Events after the reporting period

As detailed in Note 45, Íslandsbanki and Old Byr agreed in February 2019 to settle their legal dispute. It is anticipated that an equitable agreement will be reached with the Ministry. Further to this Old Byr will make a distribution in accordance with notes issued to its creditors as part of the composition of Old Byr. As a result of this, it is anticipated that the Group will recognise approximately ISK 1.5 billion in revenue, in the first quarter of 2019.

47. Risk management

Risk governance

The Group is exposed to various risk factors and managing these risks is an integral part of its operations. The Bank emphasises sound governance principles. The risk management and internal control framework of the Group is based on a three lines of defence model, as referred to in the European Banking Authority Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Group's internal rules.

The first line of defence consists of the Bank's business and support units; the second line of defence comprises the Bank's internal control units, risk management and compliance; and the third line of defence is Internal Audit which gives the Board an independent assessment of the quality of corporate governance, risk management and internal controls.

The Group's management body has a dual structure. The Board of Directors of the bank has a supervising role in setting and monitoring the execution of set policies, the sound control of accounting and financial management and ensuring that group internal audit, compliance and risk management are effective. The Chief Executive Officer (CEO), the Chief Risk Officer (CRO), other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at the Group lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through risk management policies and the Risk Appetite Statement. To assist the Board in fulfilling its oversight responsibilities, the Board has appointed three board subcommittees.

The CEO is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Group's operations are consistent with applicable legislation and the Group's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer (CRO), the Compliance Officer as well as other members of the Executive Board. The CEO also engages the members of the senior management committees.

The CRO heads the risk management function and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at the Group and for verifying that the Bank has the right resources and an appropriate organisation to manage its risks efficiently.

The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the Group and cannot be removed without the Board's prior approval.

The CRO is independent from the business units, is a member of the Executive Board and reports directly to the CEO. The CRO provides an independent view on the Group's exposure to risk. The CRO has the right but not the responsibility to veto certain risk-taking decisions of the senior management committees if an internal control unit considers the proposal inconsistent with the Bank's risk appetite, policies or procedures.

Risk management is mandated to identify, understand, measure and monitor the risks that the Group is exposed to. It provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by the management and business or support units as to whether they are consistent with the risk appetite and risk polices set by the Board.

Where necessary, risk management makes recommendations to senior management and the Board to improve or clarify risk policies, procedures and limits.

Risk Management provides a holistic view on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

Business and support units are, however, responsible for maintaining their independent view on the risks inherent in their operations and reporting to senior management any foreseeable breaches from limits, policies or strategic direction.

Risk management provides the senior management and the Board with all relevant risk related information to enable it to define the Bank's risk appetite.

The General Counsel is appointed by and reports directly to the CEO. The General Counsel provides legal advice to the Bank's senior management, including the Board of Directors, and manages the Bank's legal department which provides comprehensive legal advice to the Bank's profit centres and support units.

The Chief Audit Executive (CAE) is appointed by the Board, reports directly to Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Group, including internal audit tasks which have been outsourced.

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47. Cont'd

The Compliance Officer heads the compliance function and is responsible for defining the daily tasks of the department and assessing the adequacy of its professional skills. The Compliance Officer is responsible for monitoring the compliance risk management framework for the Bank and maintaining oversight for compliance risk throughout the Bank.

The Bank's Compliance Officer is selected and engaged by the CEO, subject to Board confirmation. The Compliance Officer cannot be removed without the Board's prior approval. The FME and Chief Audit Executive shall be notified of the dismissal or departure of the Compliance Officer.

The Compliance Officer reports directly to the Board on the overall compliance risk profile of the Bank.

Each employee is responsible for understanding the risk related to their day-to-day work, for knowing and understanding the respective internal and external rules and procedures, for using the alert procedures in the event of possible fraudulent activities and for conducting business in accordance with the Bank's code of conduct.

The Bank's senior management committee structure is twofold. Firstly the two executive committees, the Executive Board and the All Risk Committee, that are responsible for the implementation of the Board approved business strategy, risk appetite and policies. Secondly the four business committees, the Asset and Liability Committee (ALCO), the Senior Credit Committee (SCC), the Investment Committee (IC) and the Operational and Security Committee (OSC), which are responsible for the approval of business or operational proposals subject to internal rules and guidelines issued by the executive committees and the Board.

The members of the senior management committees are appointed by the CEO, and their mandate and rules of procedure are documented in a charter issued by the CEO.

48. Credit risk

Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any financial contract with the Group.

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

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

The Group has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Group'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 Group'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 Group structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Group measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

49. Maximum credit exposure

The Group's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions that have been made because of these items. The maximum credit exposure for a derivative contract is calculated by adding potential future credit exposure to the positive market value of the contract.

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

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

Credit risk exposure

49. Cont'd

Maximum credit exposure at 31 December 2018

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	135,056	-	-	-	-	-	-	-	-	-	135,056
Bonds and debt instruments	-	53,341	-	-	447	12,925	1,724	68	724	186	-	69,415
Derivatives	-	-	121	2	2,322	4,687	451	1,090	-	61	205	8,939
Loans to credit institutions	-	-	-	-	-	41,577	-	-	-	-	-	41,577
Loans to customers:	319,390	-	124,242	29,095	6,858	1,704	79,824	23,799	12,087	142,885	106,715	846,599
Overdrafts	11,769	-	11,699	3,304	31	1,509	4,483	780	754	4,501	9,751	48,581
Credit cards	15,779	-	1,516	251	4	21	433	33	112	59	34	18,242
Mortgages	249,296	-	-	-	-	-	-	-	-	-	-	249,296
Capital leases	6,504	-	27,552	2,270	5	-	7,166	116	48	1,197	258	45,116
Other loans	36,042	-	83,475	23,270	6,818	174	67,742	22,870	11,173	137,128	96,672	485,364
Other financial assets	409	-	451	5	1	6,532	23	34	3	18	35	7,511
Off-balance sheet items:	33,928	-	24,673	18,703	6,091	8,160	12,413	3,817	4,517	20,850	12,805	145,957
Financial guarantees	1,494	-	5,863	4,563	12	1,172	2,416	160	5	1,828	508	18,021
Undrawn loan commitments	-	-	4,986	11,662	5,996	-	4,899	1,100	-	14,629	5,782	49,054
Undrawn overdrafts	10,187	-	9,908	1,830	63	6,863	4,124	2,433	3,884	4,167	6,374	49,833
Credit card commitments	22,247	-	3,916	648	20	125	974	124	628	226	141	29,049
Total maximum credit exposure	353,727	188,397	149,487	47,805	15,719	75,585	94,435	28,808	17,331	164,000	119,760	1,255,054

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Maximum credit exposure at 31 December 2017

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	189,045	-	-	-	-	-	-	-	-	-	189,045
Bonds and debt instruments	-	14,716	-	-	-	9,644	1,613	95	1,022	-	-	27,090
Derivatives	2	-	212	-	1,562	2,381	296	1,465	1	206	196	6,321
Loans to credit institutions	-	-	-	-	-	26,617	-	-	-	-	-	26,617
Loans to customers:	299,350	-	112,144	24,797	7,109	26	69,961	19,726	11,871	127,067	84,853	756,904
Overdrafts	11,352	-	11,874	3,376	11	5	4,686	1,607	352	4,990	7,397	45,650
Credit cards	16,397	-	1,510	234	4	21	406	37	107	51	33	18,800
Mortgages	225,765	-	-	-	-	-	-	-	-	-	-	225,765
Capital leases	7,528	-	22,077	2,258	6	-	7,316	206	70	1,085	219	40,765
Other loans	38,308	-	76,683	18,929	7,088	-	57,553	17,876	11,342	120,941	77,204	425,924
Other financial assets	414	8	243	4	1	8,935	26	27	97	90	2	9,847
Off-balance sheet items:	38,017	1	30,269	14,909	9,646	4,640	17,050	3,774	4,875	20,404	10,304	153,889
Financial guarantees	1,607	-	5,936	4,466	13	1,169	2,389	59	4	1,006	543	17,192
Undrawn loan commitments	-	-	10,263	7,587	9,402	-	9,514	3,041	-	16,266	2,175	58,248
Undrawn overdrafts	9,977	-	9,707	2,164	201	3,351	4,044	531	4,129	2,886	7,436	44,426
Credit card commitments	26,433	1	4,363	692	30	120	1,103	143	742	246	150	34,023
Total maximum credit exposure	337,783	203,770	142,868	39,710	18,318	52,243	88,946	25,087	17,866	147,767	95,355	1,169,713

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50. Credit exposure covered by collateral

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

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

Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Group's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation. Collateral is allocated according to the gross carrying amount of loans and nominal off-balance sheet items, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their gross carrying amount, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates. The maximum credit risk exposure is measured on net carrying value basis, and therefore collateral allocation can in some instances be higher.

For capital leases the Group remains the owner of the leased object. In total ISK 35,622 million of the collateral are leased objects.

The following tables show the maximum exposure to credit risk by class of financial asset and collateral held against those exposures.

An overview of collateral held by the Group against credit exposure is shown below for exposures in Stages 1 and 2 (non credit-impaired) and exposures in Stage 3 (credit-impaired):

At 31 December 2018 **Collateral held against non credit-impaired exposures**	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral
Derivatives	8,939	-	-	2,232	-	-	2,232
Loans and commitments to customers:	978,396	563,362	89,350	6,149	49,883	69,902	778,646
Individuals	347,490	266,508	6	359	13,485	155	280,513
Commerce and services	146,286	56,407	733	189	27,574	23,915	108,818
Construction	47,495	28,694	-	379	1,880	3,761	34,714
Energy	12,949	3,737	-	366	-	5	4,108
Financial services	9,864	-	-	309	-	-	309
Industrial and transportation	89,289	39,523	9	82	6,437	15,980	62,031
Investment companies	27,392	9,588	26	2,891	83	11,361	23,949
Public sector and non-profit organisations	16,551	974	-	7	37	2	1,020
Real estate	161,864	144,530	-	1,549	231	1,113	147,423
Seafood	119,216	13,401	88,576	18	156	13,610	115,761
Total	987,335	563,362	89,350	8,381	49,883	69,902	780,878

Collateral held against credit-impaired exposures	Maximum exposure to credit risk	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Total credit exposure covered by collateral
Loans and commitments to customers:	14,160	9,003	2,282	106	328	487	12,206
Individuals	5,828	5,256	17	7	83	3	5,366
Commerce and services	2,629	1,023	139	-	78	247	1,487
Construction	303	232	-	-	21	14	267
Industrial and transportation	2,948	317	2,077	99	109	170	2,772
Investment companies	224	180	-	-	-	-	180
Public sector and non-profit organisations	53	37	-	-	-	-	37
Real estate	1,871	1,829	-	-	1	-	1,830
Seafood	304	129	49	-	36	53	267
Total	14,160	9,003	2,282	106	328	487	12,206

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The table below was prepared in accordance with IAS 39 and is therefore not fully comparable to the table above.

At 31 December 2017	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	2,351	-	-	2,351
Loans and commitments to customers:	488,494	79,699	4,601	46,888	54,093	673,775
Individuals	251,052	22	501	13,127	172	264,874
Commerce and services	49,961	857	219	25,189	17,315	93,541
Construction	20,916	-	363	1,868	4,043	27,190
Energy	3,436	-	367	-	92	3,895
Financial services	-	-	166	-	-	166
Industrial and transportation	22,386	2,876	147	6,081	14,994	46,484
Investment companies	6,579	-	2,381	104	9,164	18,228
Public sector and non-profit organisations	881	-	10	53	5	949
Real estate	126,604	-	418	221	873	128,116
Seafood	6,679	75,944	29	245	7,435	90,332
Total	488,494	79,699	6,952	46,888	54,093	676,126

51. Credit quality of financial assets

The following table provides the gross carrying amount of loans and credit risk exposure on loan commitments and financial guarantees. Amounts are broken down by risk class and the method by which their respective credit loss allowances (ECL) are calculated, i.e. Stage 1, 2 and 3 as described in Note 72.3.

The Group uses internal rating models to assess the default probability of corporate and retail customers. The models assign each customer to one of ten risk classes. One risk class is for customers in default (risk class 10), and nine risk classes are for performing customers (risk classes 1-9). Risk classes are assigned on customer level and not facility level.

The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its management, market position and industry sector.

For retail customers the Group uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Group of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits, and demographic variables to assess the probability that a customer will default on any of his obligations within 12 months of the rating assessment.

Risk classes 1-4 represent low risk, risk classes 5-6 moderate risk, risk classes 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers that are in default. Unrated are loans originating from subsidiaries of Íslandsbanki that do not have rating models, in addition to loans that are yet to be rated.

Further information on the risk classes, including the mapping from risk classes to the probability of default, can be found in Section 4.2.2 of the unaudited Pillar 3 report.

The same customer can have loans and off-balance sheet commitments in Stages 1 and 2 simultaneously. However, if a customer has an exposure in Stage 3 then all other loans and commitments are classified as Stage 3 as well.

As explained in Note 72.3, the Group has a new harmonised definition of default. The new definition is broader than each individual definition, in particular the previous definition of Risk class 10.

At 31 December 2018

Loans to customers:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	213,012	104	-	213,116
Risk class 5-6	367,843	1,055	-	368,898
Risk class 7-8	184,807	15,339	-	200,146
Risk class 9	38,633	12,363	-	50,996
Risk class 10	-	-	17,215	17,215
Unrated	4,137	41	95	4,273
	808,432	28,902	17,310	854,644
Expected credit loss	(3,277)	(1,079)	(3,689)	(8,045)
Net carrying amount	805,155	27,823	13,621	846,599

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Off-balance sheet loan commitments and financial guarantees:	Stage 1	Stage 2	Stage 3	Total
Risk class 1-4	68,712	30	-	68,742
Risk class 5-6	55,112	194	-	55,306
Risk class 7-8	16,913	1,899	-	18,812
Risk class 9	1,517	1,460	-	2,977
Risk class 10	-	-	623	623
Unrated	130	3	-	133
	142,384	3,586	623	146,593
Expected credit loss	(410)	(142)	(84)	(636)
Net carrying amount	141,974	3,444	539	145,957

At 31 December 2018	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	ECL	Total
Loans and commitments to customers:								
Individuals	74,325	135,721	101,859	33,354	6,955	3,499	(2,395)	353,318
Commerce and services	33,700	84,690	23,538	5,455	3,718	585	(2,771)	148,915
Construction	3,387	21,930	21,711	1,024	336	53	(643)	47,798
Energy	11,472	544	965	-	-	-	(32)	12,949
Financial services	9,450	419	8	-	-	4	(17)	9,864
Industrial and transportation	34,253	41,922	8,331	4,930	3,705	69	(973)	92,237
Investment companies	5,709	6,976	10,751	4,241	414	-	(475)	27,616
Public sector and non-profit organisations	13,150	3,119	240	-	52	66	(23)	16,604
Real estate	41,768	73,484	44,312	2,909	2,172	36	(946)	163,735
Seafood	54,644	55,399	7,243	2,060	486	94	(406)	119,520
Total	281,858	424,204	218,958	53,973	17,838	4,406	(8,681)	992,556

The table below was prepared in accordance with IAS 39 and shows loans to customers that were neither past due nor impaired at year-end 2017. It is not comparable to the table above which shows all loans and commitments to customers.

At 31 December 2017	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers:							
Individuals	54,270	113,333	87,600	29,999	950	3,425	289,577
Commerce and services	21,236	64,388	18,353	2,686	108	1,434	108,205
Construction	591	9,206	12,299	888	325	-	23,309
Energy	3,193	3,062	854	-	-	-	7,109
Financial services	17	4	5	-	-	-	26
Industrial and transportation	24,940	22,181	15,420	3,430	2,816	19	68,806
Investment companies	1,214	6,109	11,470	534	9	-	19,336
Public sector and non-profit organisations	7,813	3,636	410	6	-	1	11,866
Real estate	35,534	55,614	29,396	2,455	321	33	123,353
Seafood	40,854	36,896	4,351	242	1	92	82,436
Total	189,662	314,429	180,158	40,240	4,530	5,004	734,023

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52. Forbearance and write-offs

When restructuring or modification measures are believed to be more appropriate than collection procedures, the Group offers several debt relief measures and restructuring frameworks for customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants.

From 1 January 2018, when a loan has been renegotiated or modified but not derecognised the Group also reassesses, after a certain trial period, whether the loan is still considered to have a significant increase in credit risk. The Group also considers whether forborne assets classified as Stage 3 should be recognised and transferred to Stage 2.

Once an asset has been classified as forborne, it will remain forborne for a minimum 24-month probation period. In order for a loan to be reclassified out of the forborne category, the customer has to meet all of the following criteria:
- All of the customer's facilities have to be considered performing; and
- The customer does not have any contract that is more than 30 days past due; and
- The probation period of two years has passed from the date the forborne contract was considered performing; and
- Regular payments of more than an insignificant amount of principal or interest have been made during at least half of the probation period.

The following table provides a summary of the Group's forborne assets.

At 31 December 2018

	Stage 1	Stage 2	Stage 3	Total
Individuals	1,741	2,020	1,238	4,999
Companies	14,377	2,016	4,588	20,981
Gross carrying amount	16,118	4,036	5,826	25,980

	Stage 1	Stage 2	Stage 3	Total
Individuals	(13)	(92)	(198)	(303)
Companies	(139)	(49)	(1,160)	(1,348)
Expected credit loss	(152)	(141)	(1,358)	(1,651)

Gross carrying amount written off during the year and still subject to enforcement activity:	Gross carrying amount
Individuals	1,514
Companies	3,756
Total	5,270

53. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

	31.12.2018	31.12.2017
Property and land	1,072	881
Industrial equipment and vehicles	41	81

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations. The Group's employees are not permitted to purchase foreclosed assets.

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54. Large exposures disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group's capital base it is considered a large exposure. Both on-balance sheet and off-balance sheet items from all types of financial instruments are included in the exposure as defined by regulation no. 233/2017. The Group has internal criteria that define connections between clients. These criteria reflect the Group's interpretation of Article (1)(a) of the Act on Financial Undertakings no. 161/2002, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects. After mitigating effects, the Group currently has four large exposures, an increase of two since the last reporting date. No large exposure is above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects.

At 31 December 2018

Groups of connected clients:	Before	After
Group 1	73%	-
Group 2	12%	12%
Group 3	12%	11%
Group 4	11%	11%
Group 5	13%	11%

At 31 December 2017

Groups of connected clients:	Before	After
Group 1	102%	-
Group 2	11%	11%
Group 3	10%	10%

55. Liquidity risk

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

The Group's main source of funding is customer deposits. Treasury is responsible for the Bank's funding and liquidity management in line with internal and regulatory limits and policies. Treasury manages the Bank's intraday liquidity. Risk Management, as the second line of defence, is responsible for independent reporting on the liquidity position to internal and external stakeholders and providing a holistic view on liquidity risk on a consolidated basis.

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR). The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the rules on liquidity ratio and the rules on funding ratio in foreign currencies. In addition, the Group complies with the Financial Supervisory Authority's guidelines no. 2/2010 on best practices in liquidity management and liquidity coverage ratio rules no. 266/2017.

The following tables show the LCR and NSFR for the group at year-end 2018 and 2017.

Net Stable Funding Ratio	31.12.2018	31.12.2017
For all currencies	114%	117%
Foreign currencies	149%	122%

Liquidity Coverage Ratio	31.12.2018	31.12.2017
For all currencies	172%	142%
Foreign currencies	544%	155%

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At 31 December 2018	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1*	169,217	169,217	42,608	42,608
Liquid assets level 2	2,754	775	2,754	775
Total liquid assets	171,971	169,992	45,362	43,383
Deposits	455,883	127,018	67,513	25,191
Debt issued	875	875	875	875
Other outflows	72,598	32,095	15,277	5,849
Total outflows	529,356	159,988	83,665	31,915
Short term deposits with other banks**	39,718	39,718	39,716	39,716
Other inflows	42,739	21,443	9,702	7,950
Restrictions on inflows	-	-	-	(23,730)
Total inflows	82,457	61,161	49,418	23,936
Liquidity coverage ratio		172%		544%

At 31 December 2017	For all currencies		Foreign currencies	
	Unweighted	Weighted	Unweighted	Weighted
Liquid assets level 1	179,299	179,299	12,444	12,444
Liquid assets level 2	2,092	672	2,027	672
Total liquid assets	181,391	179,971	14,471	13,116
Deposits	429,365	129,957	65,502	29,500
Debt issued	575	575	56	56
Other outflows	88,979	32,192	10,928	3,534
Total outflows	518,919	162,724	76,486	33,090
Short term deposits with other banks	25,356	23,766	25,271	23,766
Other inflows	27,545	12,079	1,365	861
Total inflows	52,901	35,845	26,636	24,627
Liquidity coverage ratio		142%		155%

*Level 1 liquid assets include cash and balances with the Central Bank, domestic bonds eligible as collateral against borrowing at the CB and foreign government bonds in accordance with rules no. 266/2017 on liquidity ratio.

**Short-tem deposits with other banks with maturity less than 30 days.

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

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

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Maturity analysis 31 December 2018

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Deposits from CB and credit institutions	15,619	4,594	3,229	4,992	3,249	-	-	16,064
Deposits from customers	578,959	420,242	81,178	37,952	26,976	38,070	-	604,418
Debt issued and other borrowed funds	300,976	404	24,214	21,178	154,315	141,098	-	341,209
Subordinated loans	16,216	-	90	307	2,242	20,417	-	23,056
Other financial liabilities	27,186	24,431	1,729	1,026	-	-	-	27,186
Total	938,956	449,671	110,440	65,455	186,782	199,585	-	1,011,933

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

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	18,021	-	-	-	-	-	18,021
Undrawn loan commitments	49,054	-	-	-	-	-	49,054
Undrawn overdrafts	49,833	-	-	-	-	-	49,833
Credit card commitments	29,049	-	-	-	-	-	29,049
Total	145,957	-	-	-	-	-	145,957
Total non-derivative financial liabilities and off-balance sheet liabilities	595,628	110,440	65,455	186,782	199,585	-	1,157,890

The table below shows the contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative and a positive carrying amount at the reporting date. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	20,124	23,147	49,380	1,771	-	94,422
Outflow	-	(20,638)	(24,189)	(51,654)	(1,943)	-	(98,424)
Total	-	(514)	(1,042)	(2,274)	(172)	-	(4,002)
Net settled derivatives	-	(280)	-	-	-	-	(280)
Total	-	(794)	(1,042)	(2,274)	(172)	-	(4,282)

Maturity classification of assets is based on contractual maturity. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity dates while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

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Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	135,056	47,746	87,310	-	-	-	-	135,056
Bonds and debt instruments	69,415	-	18,946	24,189	14,409	11,604	267	69,415
Shares and equity instruments	13,074	-	-	-	-	-	13,074	13,074
Loans to credit institutions	41,577	24,152	17,425	-	-	-	-	41,577
Loans to customers	846,599	2,054	90,269	74,716	282,624	396,936	-	846,599
Other financial assets	7,511	1,888	475	71	9	-	5,068	7,511
Total	1,113,232	75,840	214,425	98,976	297,042	408,540	18,409	1,113,232

Derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	57,050	22,267	77,126	327	-	156,770
Outflow	-	(56,077)	(21,929)	(74,072)	(343)	-	(152,421)
Total	-	973	338	3,054	(16)	-	4,349
Net settled derivatives	-	869	-	-	-	-	869
Total	-	1,842	338	3,054	(16)	-	5,218

The tables below show the comparative amounts for financial assets and financial liabilities at year-end 2017.

Maturity analysis 31 December 2017

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	270	270	-	-	-	-	-	270
Deposits from CB and credit institutions	11,189	6,104	3,078	-	2,246	-	-	11,428
Deposits from customers	567,029	388,943	92,487	51,156	25,109	29,080	-	586,775
Debt issued and other borrowed funds	217,748	436	3,222	36,568	132,831	79,152	-	252,209
Subordinated loans	9,505	-	36	138	1,257	12,356	-	13,787
Other financial liabilities	10,467	6,181	3,273	1,012	-	-	-	10,466
Total	816,208	401,934	102,096	88,874	161,443	120,588	-	874,935

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	17,192	-	-	-	-	-	17,192
Undrawn loan commitments	58,248	-	-	-	-	-	58,248
Undrawn overdrafts	44,426	-	-	-	-	-	44,426
Credit card commitments	34,023	-	-	-	-	-	34,023
Total	153,889	-	-	-	-	-	153,889
Total non-derivative financial liabilities and off-balance sheet liabilities	555,823	102,096	88,874	161,443	120,588	-	1,028,824

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Notes to the Consolidated Financial Statements

55. Cont'd

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	23,143	48,265	43,880	5,115	-	120,403
Outflow	-	(23,558)	(48,108)	(47,170)	(5,631)	-	(124,467)
Total	-	(415)	157	(3,290)	(516)	-	(4,064)
Net settled derivatives	-	(170)	-	-	-	-	(170)
Total	-	(585)	157	(3,290)	(516)	-	(4,234)

Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	189,045	31,396	153,098	-	-	4,551	-	189,045
Bonds and debt instruments	27,090	998	8,896	2,590	7,298	7,308	-	27,090
Shares and equity instruments	10,177	-	-	-	-	-	10,177	10,177
Loans to credit institutions	26,617	15,050	11,567	-	-	-	-	26,617
Loans to customers	755,175	4,172	77,809	84,286	220,524	370,113	-	756,904
Other financial assets	9,847	3,860	524	10	32	6	5,415	9,847
Total	1,017,951	55,476	251,894	86,886	227,854	381,978	15,592	1,019,680

Derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	25,982	52,964	30,231	813	-	109,990
Outflow	-	(24,827)	(51,416)	(28,728)	(880)	-	(105,851)
Total	-	1,155	1,548	1,503	(67)	-	4,139
Net settled derivatives	-	233	-	-	-	-	233
Total	-	1,388	1,548	1,503	(67)	-	4,372

As a part of managing liquidity risk, the Group holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Group's liquid assets.

Composition and amount of liquid assets and deposits with other banks	31.12.2018	31.12.2017
Cash and balances with Central Bank	117,573	183,834
Domestic bonds eligible as collateral against borrowing at Central Bank	10,532	3,654
Foreign government bonds	41,588	11,872
Loans to credit institutions	39,718	23,768
Total	209,411	223,128

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56. Deposits by LCR category

The Group's deposits are categorised by counterparty according to the Liquidity Coverage Ratio (LCR) standard. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classified as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme. There is a difference between a few categories when comparing 2018 and 2017. A few lines have been combined in the 2018 table in order to be in line with the EBA LCR report.

	Deposits maturing within 30 days					
At 31 December 2018	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	216,428	12%	80,804	5%	78,476	375,708
Operational relationships	2,572	25%	-	5%	-	2,572
Corporations	63,887	40%	341	20%	22,809	87,037
Sovereigns, Central Bank and public sector entities	7,613	40%	246	20%	591	8,450
Pension funds	30,686	100%	-	-	26,987	57,673
Domestic financial entities	27,467	100%	-	-	24,622	52,089
Foreign financial entities	3,242	100%	-	-	7,807	11,049
Total	351,895		81,391		161,292	594,578

	Deposits maturing within 30 days					
At 31 December 2017	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	118,964	10%	63,715	5%	68,808	251,487
SMEs	55,958	10%	15,024	5%	6,847	77,829
Operational relationships	1,694	25%	-	5%	-	1,694
Corporations	64,114	40%	321	20%	27,327	91,762
Sovereigns, Central Bank and public sector entities	7,083	40%	234	20%	1,513	8,830
Financial institutions in composition	2,947	100%	-	-	-	2,947
Pension funds	31,271	100%	-	-	28,466	59,737
Domestic financial entities	30,849	100%	-	-	26,979	57,828
Foreign financial entities	4,868	100%	-	-	4,353	9,221
Other foreign entities	8,718	100%	2,214	25%	5,951	16,883
Total	326,466		81,508		170,244	578,218

57. Market risk

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

Market risk within the Group can broadly be split into two categories, trading book and banking book. The trading book includes market risk exposures related, directly or indirectly, to the Group's short- and medium-term trading in securities, currencies and other capital market instruments and derivatives. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. The banking book includes market risk exposures related to securities held for long-term investment purposes, unlisted securities or holdings in subsidiaries or affiliates. A large part of the banking book market risk is due to mismatches in the composition of assets and liabilities, for example with respect to currencies, interest rates, CPI-indexation or other factors that can affect the Group's earnings or earnings volatility. These mismatches are reported to management and are subject to internal and regulatory limits.

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58. Interest rate risk

Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates.

Sensitivity measures like Basis Point Value (BPV) are used to measure and manage risk arising from its fixed income exposures. The BPV measures the effect of a 0.01 percentage point upward parallel shift in the yield curve on the fair value of these exposures.

59. Interest rate risk in the trading book

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing Financing Fund (HFF) which are guaranteed by the Icelandic Government, domestic municipality bonds and covered bonds issued by other Icelandic banks. Bonds and bills in the Group's liquidity portfolio are also categorised in the trading book. In the table below the total market value (MV) of long and short positions may not be the same as reported in Note 6 since netting between short and long positions is not applied here. Derivatives and securities used for hedging are excluded from the table.

	31.12.2018			31.12.2017		
Trading bonds and debt instruments, long positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	1,872	6.13	(1.15)	1,750	7.17	(1.25)
Non-indexed	43,550	0.32	(1.40)	14,148	0.51	(0.73)
Total	45,422	0.56	(2.55)	15,898	1.24	(1.98)

	31.12.2018			31.12.2017		
Trading bonds and debt instruments, short positions	MV	Duration	BPV	MV	Duration	BPV
Indexed	-	-	-	-	-	-
Non-indexed	198	5.00	0.09	-	-	-
Total	198	5.00	0.09	-	-	-
Net position of trading bonds and debt instruments	45,224	0.54	(2.46)	15,898	1.24	(1.98)

60. Sensitivity analysis for interest rate risk in the trading book

The following table shows the interest rate sensitivity of the Group's trading book from a parallel 100 basis points change in all yield curves.

Sensitivity analysis for trading bonds and debt instruments		31.12.2018		31.12.2017	
		Profit (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	100	115	(115)	125	(125)
ISK, non-indexed	100	24	(24)	50	(50)
EUR	100	56	(56)	4	(4)
USD	100	29	(29)	14	(14)
Other total	100	-	-	6	(6)
Total		224	(224)	199	(199)

61. Interest rate risk in the banking book

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

The impact on the Group's interest rate risk in the banking book due to the Supreme Court ruling on 12 October 2017 regarding interest rate reset terms on consumer mortgage contracts was not considered at year-end 2017 but is now taken into account. Part of the borrowers owing mortgage loans where the Group will not be able to reset interest rates have been asked to disclose their preferences with regards to refinancing and updating of the loan contracts. The number of remaining contracts is approximately 2,700 with a carrying amount of ISK 36 billion. In order to categorise those contracts in appropriate time buckets the Bank uses an internal model to estimate their expected time to maturity.

The following table shows the interest sensitivity of the Group's banking book from a parallel 100 basis points change in all yield curves, with all other variables held constant, categorised by the date of next interest rate reset.

Sensitivity analysis for interest rate risk in the banking book

At 31 December 2018

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	20	8	110	(3,318)	3,185	72	77
ISK, non-indexed	9	57	(7)	(193)	(77)	(1)	(212)
EUR	87	(25)	13	(1,605)	1,709	-	179
SEK	92	-	(16)	-	-	-	76
USD	(63)	-	-	-	-	-	(63)
Other	(1)	(11)	-	-	-	-	(12)
Total	144	29	100	(5,116)	4,817	71	45

At 31 December 2017

Currency	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
ISK, indexed	-	(48)	(280)	(2,833)	2,924	989	752
ISK, non-indexed	53	(34)	140	(334)	310	(2)	133
EUR	34	(45)	84	(102)	-	-	(29)
SEK	27	-	-	-	-	-	27
USD	4	(54)	-	-	-	-	(50)
Other	18	(18)	-	-	-	-	-
Total	136	(199)	(56)	(3,269)	3,234	987	833

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62. Currency risk

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

The analysis of the Group's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements.

Currency analysis at 31 December 2018

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	377	250	135	23	10	54	51	88	29	73	1,090
Bonds and debt instruments	32,313	10,968	24	-	-	-	-	-	-	-	43,305
Shares and equity instruments	45	2,202	398	-	-	-	40	-	-	-	2,685
Loans to credit institutions	15,662	12,614	4,488	258	613	4,683	1,901	530	123	538	41,410
Loans to customers	105,852	31,603	2,037	734	3,213	2	4,318	572	5,710	39	154,080
Other assets	1,270	2,056	834	4	91	83	2	45	-	1,737	6,122
Total assets	155,519	59,693	7,916	1,019	3,927	4,822	6,312	1,235	5,862	2,387	248,692
Liabilities											
Deposits from credit institutions	5,622	538	83	-	96	-	16	-	-	-	6,355
Deposits from customers	26,605	26,819	4,293	329	430	927	3,211	1,728	434	144	64,920
Debt issued and other borrowed funds	113,670	-	-	-	-	41,764	-	-	-	-	155,434
Subordinated loans	-	-	-	-	-	16,216	-	-	-	-	16,216
Other liabilities	2,502	1,269	578	30	266	82	154	138	-	2,098	7,117
Total liabilities	148,399	28,626	4,954	359	792	58,989	3,381	1,866	434	2,242	250,042
Net on-balance sheet position	7,120	31,067	2,962	660	3,135	(54,167)	2,931	(631)	5,428	145	(1,350)
Net off-balance sheet position	(7,589)	(31,140)	(2,964)	(667)	(3,170)	54,350	(2,844)	642	(5,418)	(147)	1,053
Net position	(469)	(73)	(2)	(7)	(35)	183	87	11	10	(2)	(297)

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Currency analysis at 31 December 2017

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	CAD	Other foreign currencies	Total foreign currencies
Cash and balances with Central Bank	238	124	78	19	5	39	30	60	26	39	658
Bonds and debt instruments	7,253	3,688	23	-	-	-	2,544	-	-	-	13,508
Shares and equity instruments	29	1,467	-	-	-	-	37	-	-	80	1,613
Loans to credit institutions	6,177	12,095	620	907	344	2,514	1,804	778	129	716	26,084
Loans to customers	92,179	19,693	2,287	1,220	3,198	3	4,791	673	4,166	47	128,257
Other assets	874	788	570	5	51	27	2	30	11	1,359	3,717
Total assets	106,750	37,855	3,578	2,151	3,598	2,583	9,208	1,541	4,332	2,241	173,837
Liabilities											
Deposits from credit institutions	2,366	378	-	4	4	-	-	-	-	-	2,752
Deposits from customers	25,396	24,405	4,468	190	336	703	2,683	2,452	358	22	61,013
Debt issued and other borrowed funds	87,166	-	-	-	-	7,660	6,391	-	-	-	101,217
Subordinated loans	-	-	-	-	-	9,505	-	-	-	-	9,505
Other liabilities	2,994	2,577	559	9	202	65	4	45	30	1,875	8,360
Total liabilities	117,922	27,360	5,027	203	542	17,933	9,078	2,497	388	1,897	182,847
Net on-balance sheet position	(11,172)	10,495	(1,449)	1,948	3,056	(15,350)	130	(956)	3,944	344	(9,010)
Net off-balance sheet position	11,492	(11,572)	1,466	(1,952)	(3,101)	15,390	(353)	1,022	(3,981)	(149)	8,262
Net position	320	(1,077)	17	(4)	(45)	40	(223)	66	(37)	195	(748)

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63. Sensitivity analysis for currency risk

The table below shows the effect of a 10% depreciation or appreciation of FX rates where the Group had positions at the reporting date, with all other variables held constant.

Sensitivity analysis for currency risk	31.12.2018		31.12.2017	
	Profit or (loss)			
Currency	-10%	10%	-10%	10%
EUR	47	(47)	(32)	32
USD	7	(7)	108	(108)
GBP	-	-	(2)	2
CHF	1	(1)	-	-
JPY	4	(4)	5	(5)
SEK	(18)	18	(4)	4
NOK	(9)	9	22	(22)
DKK	(1)	1	(7)	7
CAD	(1)	1	4	(4)
Other currencies	-	-	(20)	20
Total	30	(30)	74	(74)

64. Shares and equity instruments

The Group's equity exposure in the trading book arises from flow trading and market making with shares listed on the Nasdaq Iceland Stock Exchange. Shares and equity instruments in the banking book are classified as mandatorily at fair value through profit or loss or are classified as held for sale.

65. Sensitivity analysis for shares and equity instruments

The table shows how a 10% shift in equity prices would affect the Group's equity and net financial income. Securities used for hedging are excluded.

Sensitivity analysis for shares and equity instruments		31.12.2018		31.12.2017	
		Profit or (loss)			
Portfolio	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading book	10%	(123)	123	(174)	174
Banking book	10%	(639)	639	(508)	508
Total		(762)	762	(682)	682

66. Derivatives

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. However, the Group is subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and collateral requirements. Other derivatives held for trading or for other purposes are insignificant.

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67. Inflation risk

The Group is exposed to inflation risk since the value of CPI-linked assets exceeds CPI-linked liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI affect profit and loss. A 1% increase in the index would lead to an ISK 120 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant.

Assets, CPI-linked	31.12.2018	31.12.2017
Bonds and debt instruments	2,721	2,442
Loans to customers	293,917	270,533
Off-balance sheet position	-	506
Total assets	296,638	273,481
Liabilities, CPI-linked		
Deposits from customers	95,917	92,077
Debt issued and other borrowed funds	118,103	91,351
Off-balance sheet position	70,617	62,569
Total liabilities	284,637	245,997
CPI imbalance	12,001	27,484

68. Capital management

The following table shows the capital base, risk exposure amount, the resulting capital ratios, and leverage for the Group at 31 December 2018 and 31 December 2017.

The Group's regulatory capital requirement is calculated according to CRD IV as implemented through Act no. 161/2002 on Financial Undertakings and regulation no. 233/2017 on prudential requirements for financial undertakings. Capital requirement calculations for credit risk and market risk are based on the standardised approach whereas the capital requirement calculations for operational risk are based on the basic indicator approach.

The Group aims at managing its capital position and the corresponding capital ratios above the overall regulatory capital requirement. According to the latest SREP report from the Financial Supervisory Authority, published in October 2018, the overall capital requirement is 18.8%, increasing to 19.3% in May 2019 when the countercyclical buffer will increase by 0.5%. The Group's capital target includes a 0.5-2.0% management buffer on top of the overall capital requirement.

The minimum leverage ratio for Icelandic financial institutions is 3%.

	31.12.2018	31.12.2017
CET1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Reserves	6,499	6,179
Retained earnings	102,496	107,387
Non-controlling interests	2,318	2,479
Fair value changes due to own credit standing	376	-
Tax assets	(215)	(4)
Intangible assets	(5,002)	(4,231)
Other regulatory adjustments	-	(1,285)
Total CET1 capital	171,472	175,525
Tier 2 capital		
Qualifying subordinated liabilities	16,216	9,505
General credit risk adjustments	-	1,729
Total capital base	187,688	186,759

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	31.12.2018	31.12.2017
Risk exposure amount		
- due to credit risk	750,801	682,525
- due to market risk	7,622	8,102
Market risk, trading book	6,649	6,709
Currency risk	973	1,393
- due to credit valuation adjustment	2,385	1,534
- due to operational risk	85,141	83,331
Total risk exposure amount	845,949	775,492
Capital ratios		
CET1 ratio	20.3%	22.6%
Total capital ratio	22.2%	24.1%
Leverage ratio		
Exposure amount		
On-balance sheet exposures	1,120,637	1,026,879
Off-balance sheet exposures	47,119	51,328
Derivative exposures	8,935	6,334
Leverage ratio total exposure measure	1,176,691	1,084,541
Tier 1 capital	171,473	175,525
Leverage ratio	14.6%	16.2%

69. Operational risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Goup's definition of operational risk includes reputational risk, legal risk, model risk, conduct risk and compliance risk among other risk factors.

The ultimate responsibility for ensuring an adequate operational risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board has approved an Operational Risk Policy which outlines the Bank's framework for operational risk management.

Risk Management is responsible for implementing the Bank's operational risk framework, for developing, maintaining the Operational Risk Policy and for communicating the policy to the Bank's employees.

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Notes to the Consolidated Financial Statements

Accounting policies

70. 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, short positions in listed bonds, derivative financial instruments and certain debt securities.

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

Recognised financial liabilities designated as hedged items in qualifying fair value hedge relationships are measured at amortised cost adjusted for changes in fair value attributable to the risk being hedged.

71. Changes in presentation

As a result of the application of IFRS 15, the Group has changed its presentation in the consolidated income statement as follows:
- Insurance and wholesale annual fees related to credit cards were presented as an expense in the line item "Fee and commission expense" before 1 January 2018 but they are presented as a deduction from revenue in the line item "Fee and commission income" from 1 January 2018. This change in presentation has no effect on the net fee and commission income.

72. Significant accounting policies

The accounting policies set out below have been applied consistently by the Group to the periods presented in these consolidated financial statements.

At 1 January 2018 the Group implemented IFRS 9 and elected not to restate comparative period information. Accordingly, comparative periods are presented in accordance with IAS 39 as described in the Group's audited consolidated financial statements for the year ended 31 December 2017.

Set out below is an index of the significant accounting policies, the details of which are available on the pages that follow.

Contents

72.1 Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries presented as those of a single economic entity. The Group consolidates its subsidiaries on the basis of control whereas subsidiaries are entities controlled by the Group.

Control

The Group controls an entity when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

The Group is exposed, or has rights, to variable returns from its involvement with an entity when the Group's returns from its involvement have the potential to vary as a result of the entity's performance.

The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the entity's returns.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

When the Group assesses whether it controls an entity, it also determines whether it is a principal or an agent. If the Group has the power to direct the activities of the entity to generate returns for itself, then it is a principal. If the Group is primarily engaged to act on behalf and for the benefit of other parties, then it is an agent and it does not control the entity when exercising its decision-making rights delegated to it. In assessing whether the Group is a principal or an agent it considers the overall relationship between itself, the entity and other parties involved with the entity. In particular, the Group considers the scope of its decision-making authority over the entity, the rights held by other parties, the remuneration to which it is entitled in accordance with any remuneration agreements and the Group's exposure to variability of returns from other interests that it holds in the entity. Different weightings are applied to each of these factors on the basis of particular facts and circumstances.

The Group reassesses whether or not it controls an entity if facts and circumstances indicate that there are changes to one or more of the elements of control.

Funds management

The Group acts as a fund manager or an investment adviser for investment funds. The purpose of these investment funds is to earn commission income from asset management for third parties. Such investment funds are financed by issuing unit holdings to investors. The Group does not have any contractual financial responsibility with respect to such custom units. The funds are not consolidated unless they are under the control of the Group.

The Group reviews all the facts and circumstances in order to decide if an investment fund should be consolidated. The Group is deemed to be a principal and hence controls and consolidates the funds, when it acts as fund manager and cannot be removed without cause, has variable returns through significant unit holdings and/or guarantee, and is able to influence the returns of the funds by exercising its power.

Consolidation

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group loses control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities are eliminated in full on consolidation. The carrying amount of Íslandsbanki's investment in each subsidiary and Íslandsbanki's portion of equity of each subsidiary are eliminated and any related goodwill is recognised as an asset.

When the Group is committed to a sale plan involving the loss of control of a subsidiary and the criteria for classification as held for sale are met (see Note 72.11), it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements. This is regardless of whether the Group will retain a non-controlling interest in the subsidiary after the sale.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 72.24), the Group presents the gain or loss from disposal in the income statement in the line item "Profit (loss) from discontinued operations, net of income tax".

If the Group loses control of a subsidiary, it derecognises the related assets (including goodwill), liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss. Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

72.1 Cont'd

Non-controlling interests

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination, the Group measures at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

The Group presents non-controlling interests within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki and to non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

When the proportion of the equity held by non-controlling interests changes, the Group adjusts the carrying amounts of the controlling and non-controlling interests to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to equity holders of Íslandsbanki hf. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

Business combinations and goodwill

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

72.2 Foreign currencies

The financial statements of each of the Group's entities are measured using the functional currency of the respective entity.

Transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into functional currencies at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, adjusted for effective interest and payments during the year, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the year.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the spot exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are measured at fair value are translated 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 (see Note 72.19).

72.3 Financial assets and financial liabilities

Recognition

The Group recognises a financial asset or a financial liability in its statement of financial position on the trade date, which is the date on which the Group becomes party to the contractual provisions of the instrument, except for loans which are recognised on the date when cash is advanced by the Group to the borrowers. At initial recognition, the Group measures a financial asset or a financial liability at its fair value plus, in the case of a financial asset or a financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or the financial liability.

Derecognition

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled, or expire.

The Group derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

72.3 Cont'd

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

The Group enters into transactions whereby it transfers assets recognised in its statement of financial position, but retains either all or substantially 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 statement of financial position of the Group. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Group does not derecognise from its statement of financial position securities which the Group 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 Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

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

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Modifications

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value.

Classification and measurement

Financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories (see also Note 6):

- Financial assets measured at amortised cost
- Financial assets at fair value through other comprehensive income
- Financial assets at fair value through profit or loss, either as:
  - financial assets mandatorily at fair value through profit or loss; or
  - financial assets designated as at fair value through profit or loss
- Derivative assets held for hedging

The measurement basis of individual financial assets is determined based on an assessment of the cash flow characteristics of the assets and the business models under which they are managed.

The business models

The business models are determined by the Group's key management personnel in the way that assets are managed and their performance is reported to them. The Group determines its business models at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. This condition is not an instrument-by-instrument approach to classification, but is determined at a higher level of aggregation. The Group's business models fall into the following three categories: Held to collect, Held to collect and for sale, and Other fair value business models, where assets are held for trading or managed on a fair value basis and are neither Held to collect nor Held to collect and for sale.

Solely payments of principal and interest (SPPI)

Financial assets held within the business models Held to collect and Held to collect and for sale, are assessed to evaluate if their contractual cash flows are comprised of solely payments of principal and interest. SPPI payments are those which are consistent with a basic lending arrangement. Principal is the fair value of the financial asset at initial recognition and changes over the life of the financial asset, for example if there are repayments of principal. Interest relates to basic lending returns, including compensation for the time value of money and credit risk associated with the principal amount outstanding over a period of time. Interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs), as well as a profit margin that is consistent with a basic lending arrangement.

Where the contractual terms introduce exposure to risk or variability of cash flows that are inconsistent with a basic lending arrangement, the related financial asset is classified and measured at fair value through profit or loss.

72.3 Cont'd

Financial assets measured at amortised cost

A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows, i.e. Held to collect.

Financial assets at amortised cost are measured using the effective interest method. Amortised cost is calculated by taking into account the amount at which the assets are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment. Accrued interest is included in the carrying amount of the financial asset in the statement of financial position.

Impairment losses and reversals of impairment losses are recognised in profit or loss in the line item "Net impairment on financial assets".

Financial assets at fair value through other comprehensive income (FVOCI)

For shares and equity instruments that are not held for trading, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. This election is made on an instrument-by-instrument basis. Shares and equity instruments at FVOCI are not subject to an impairment assessment. Dividends are to be presented in profit or loss, as long as they represent a return on investment. On derecognition there is no recycling of fair value gains and losses to profit or loss.

Financial assets at fair value through profit or loss (FVTPL)

Financial assets classified at fair value through profit or loss are all other financial assets which are not classified at amortised cost or at fair value through other comprehensive income. This includes financial assets classified mandatorily at fair value through profit or loss and financial assets which are irrevocably designated by the Group at initial recognition as at fair value through profit or loss that would otherwise meet the requirements to be measured at amortised cost or at FVOCI. The Group designates financial assets as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise. During the year the Group did not classify any financial assets as designated at fair value through profit or loss.

Financial assets at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned, which is recognised in the line item "Interest income" and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)".

Derivative assets held for hedging

Derivative assets held for hedging consist of derivatives with positive fair value which are designated and accounted for as hedging instruments (see Note 72.5).

Financial liabilities

For the purpose of measuring its financial liabilities, the Group classifies them at inception in one of the following categories (see also Note 6), except for loan commitments and financial guarantees (see Note 72.12):

- Financial liabilities measured at amortised cost
- Financial liabilities mandatorily at fair value through profit or loss
- Financial liabilities designated as at fair value through profit or loss
- Derivative liabilities held for hedging

Financial liabilities measured at amortised cost

Financial liabilities measured at amortised cost are non-derivative financial liabilities. 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 the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums 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 statement of financial position.

72.3 Cont'd

The amortised cost of certain bonds issued by the Group, which are designated as hedged items in qualifying fair value hedge relationships, is adjusted for changes in the fair value of the bonds attributable to interest rate risk (see Note 72.5).

Financial liabilities mandatorily at fair value through profit or loss
Financial liabilities mandatorily at fair value through profit or loss are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities mandatorily at fair value through profit or loss consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities mandatorily at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Financial liabilities designated as at fair value through profit or loss
Financial liabilities designated as at fair value through profit or loss are recognised at fair value and changes in fair value attributable to changes in the credit risk of those liabilities are recognised in other comprehensive income and are not subsequently reclassified to profit or loss. The remaining fair value changes are included in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" using the effective interest rate method and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

The Group calculates the fair value attributable to changes in credit risk as the difference between the changes in fair value of the financial liability and the amount of changes in fair value attributable to changes in market interest rates. The change in fair value attributable to changes in market interest rates on financial liabilities is calculated by discounting contractual cash flows at the end of the period with the discount rate of the appropriate market interest rate.

Upon initial recognition, the Group determines if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, if applicable the whole fair value change is presented in profit or loss.

Derivative liabilities held for hedging
Derivative liabilities held for hedging consist of derivatives with negative fair value which are designated and accounted for as hedging instruments (see Note 72.5).

Reclassification
Financial assets are reclassified between measurement categories if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the Group's operations.
Financial liabilities are not reclassified.

Offsetting financial assets and financial liabilities
Financial assets and financial liabilities are offset and the net amount presented in the consolidated statement of financial position when, and only when, the Group has a legal right to set off the amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Determination of fair value
The fair value of a financial instument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the reporting date.

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which observable market prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate.

Periodically, the Group tests the valuation techniques and calibrates against historical data and using prices from observable current market transactions for the same instrument, or based on other available observable market data.

Changes in the fair value of financial assets and financial liabilities are recognised in profit or loss in the line item "Net financial income (expense)".

72.3 Cont'd

The Group has an established control framework with respect to the measurement of fair values. The business unit owning the positions is responsible for their valuations and for submitting the valuation to the Bank's Investment Committee for approval. Risk Management provides an independent review of the results, the valuation methods used and of the use of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's Investment Committee.

Impairment of financial assets

The adoption of IFRS 9 has had a significant impact on the Group's impairment methodology. The two main reasons for this impact are firstly that the impairment model of IFRS 9 is forward-looking as opposed to the incurred loss model of IAS 39 and secondly that impairment under IFRS 9 should reflect a probability weighted average of possible outcomes in contrast to IAS 39 where the single most likely outcome was accounted for. In addition, the expected credit loss model in IFRS 9 employs a dual measurement approach, under which the loss allowance for expected credit losses (ECL) is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk (SICR) of the financial instrument since initial recognition. To satisfy the provisions of the IFRS 9 standard, a significant amount of modelling must be involved. The models which the Group uses for the calculation of the impairment amount are developed according to the Group's modelling framework. This framework imposes structure on the initial model development work, the model documentation including educational material as needed for users, the approval process for models, the implementation of models and the lifetime support for models, including validation and back-testing. The Group's impairment process, which encompasses all the steps needed to derive the appropriate impairment allowance for each accounting period, is documented and approved by the All Risk Committee.

Stage assignment

At each reporting date, all assets subject to the impairment methodology must be divided into three groups, termed "Stages", reflecting the extent of credit deterioration since initial recognition. This division then has an effect on how the impairment is measured and how interest is recognised.

Stage 1 – All assets that have not experienced a SICR are assigned to Stage 1. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from credit events occurring within 12 months of the reporting date (12-month ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 2 – Assets that the Group determines to have experienced a SICR, but are not credit-impaired, are classified as Stage 2. For these assets, an impairment allowance is recognised which is equal to the expected credit loss arising from all credit events occurring within the expected lifetime of the assets (lifetime ECL). Interest is recognised on the gross carrying amount of the assets.

Stage 3 – This Stage is for assets which are credit-impaired according to the Group's assessment. These assets are therefore experiencing an ongoing credit event. Thus, the 12-month ECL and lifetime ECL are the same amount and this amount is recognised as impairment allowance. For assets in this Stage, interest is recognised on the gross carrying amount of assets, net of impairment allowance.

The Group's definition of being credit-impaired is on a customer level, rather than on the level of an individual asset. According to the definition, a customer is credit-impaired when either of the following holds:
a) The Group assesses that it is unlikely that the customer can service all of their commitments to the Group in accordance with the terms of the agreements without recourse to default provisions in the agreements or
b) The customer is more than 90 days past due on any of their commitments

The assessment in point a) is made based on a defined set of triggers, which includes serious breach of covenants, serious registrations on an internal watchlist, initiation of serious collection actions and serious external credit related information.

Furthermore, there is a defined set of conditions which must be satisfied so that customers that have been assessed as being credit-impaired are no longer subject to this assessment. This includes probation periods and a view to the future outlook of the customer.

The Group's definition of a SICR is on the level of an individual asset. The Group assesses that there has been a significant increase in credit risk of an asset if the probability of a credit impairment event, i.e. transfer to Stage 3, occurring over the lifetime of the asset has increased significantly from the origination of the assets. For this purpose, origination does not refer to any modification events which have not resulted in derecognition of the asset. The assessment is based on a defined set of triggers. This includes, as a backstop, the trigger that the asset is more than thirty days past due. Other triggers are internal assessments of outlook, events such as forbearance events which are less severe than a credit event, external credit related information and a significant deterioration in risk assessment compared with the risk assessment done in relation to the origination of the asset. The definition of SICR depends only on the probability of a credit event occurring, it does not take into account collateralisation or any other information related to the expected loss arising from the event.

72.3 Cont'd

The Group does not employ the low credit risk exemption in the Stage assignment process. In alignment with its operating procedures, the Group has chosen as its accounting policy to measure the impairment allowance for lease receivables at an amount equal to the lifetime ECL only for those assets which have a SICR or are credit-impaired. For other lease receivables the impairment allowance is equal to the 12-month ECL.

Expected credit loss (ECL)
The ECL for each asset is calculated using models for the probability of a credit impairment event occurring (PD), the loss percentage expected in case of such an event (LGD) and the outstanding amount at the time of the event (EAD). In its simplest form the ECL can be calculated as the product of these factors, however, for several reasons, the actual formula must be more complicated than this.

The Group uses the standardised approach for regulatory capital purposes but has used PD models and LGD models for risk management purposes for several years. These models have been adapted for IFRS 9 purposes. For EAD, and for LGD to a certain extent, new models have been developed.

The PD models are either fully automated statistical models, expert models or hybrid. For the models with a component involving expert input there is a process in place to ensure proper review of the model outcome and periodic reassessment of obligors. The inputs into the models include demographic variables, information from financial statements and past payment behaviour, among other variables.

The effects of the economy on the PD is accounted for through the use of scaling factors which map through-the-cycle PD values to point-in-time PD values. The Group has a model to predict these scaling factors based on economic forecasts. The economic forecasts used are provided at least quarterly by the Group's Chief Economist and approved by the All Risk Committee. The Group uses several economic scenarios which have different scaling factors in order to represent the whole range of possible future economic developments. The actual impairment allowance is the weighted average of the ECL in these different scenarios.

The LGD model considers several scenarios for how a facility may develop once a credit event has occurred. One possibility is that the facility cures without a loss. If not, the recoveries may be based on the seizing of collateral and to estimate such recoveries it is appropriate to consider several scenarios for the development of the value of the collateral. Finally, there may be recoveries even though a formal collateral is not in place. These different recovery scenarios are weighted differently depending on the economic scenario under consideration. This leads to a non-linear interaction and thus a difference between the probability weighted average ECL and the ECL in the most likely scenario.

For EAD it is necessary to account for expected prepayments on term loans and for the expected utilisation of commitments such as credit cards, overdrafts, financial guarantees and credit lines. The expected lifetime of agreements may also extend beyond the contractual lifetime for contracts which are generally extended.

Write-off policy
The Group writes off a financial asset, either partially or in full, when there is no realistic prospect of recovery. Where financial assets are secured, write-off is generally after receipt of any proceeds from the realisation of security. In subsequent periods, any recoveries of amounts previously written off are credited to the consolidated income statement.

The impairment process
In the Group's impairment framework, the Stage assignment and ECL for each financial asset is calculated from the aforementioned models. The outcome is reviewed by the business units and they can propose changes if they provide sufficient supporting material. The impairment and any proposals for changes are reviewed by an Impairment Council appointed by the All Risk Committee and the impairment allowance is approved by the All Risk Committee on a quarterly basis.

The principle of materiality applies to the above discussion on impairment, whereby exceptions related to non-materiality and immaterial adjustments are not discussed.

72.4 Derivative financial instruments

Derivatives are primarily used in trading activities but are also used to manage the Group's exposure to various risks, such as interest rate risk, inflation risk and currency risk. Derivatives which do not classify as equity instruments of the Group are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities).

When derivatives are embedded in other financial instruments or host contracts, such combinations are known as hybrid instruments with the effect that some of the cash flows of a hybrid instrument vary in a way similar to a stand-alone derivative. These embedded derivatives are measured and presented in the consolidated financial statements as if they were free-standing derivatives.

72.4 Cont'd

The Group accounts for an embedded derivative seperately from the host contract when, the host contract is not an asset in the scope of IFRS 9, is not carried at fair value through profit and loss, the terms of the embedded derivative would meet the definition of a derivative if they were contained in a separate contract, and the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract. When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

The Group applies hedge accounting. Accordingly, some of the Group's derivative financial assets and liabilities are accounted for as financial assets or financial liabilities mandatorily at fair value through profit or loss while others are accounted for as derivative assets or liabilities held for hedging (see Note 72.3 and Note 72.5).

72.5 Fair value hedge accounting

The Group applies fair value hedge accounting with respect to designated hedging relationships consisting of certain fixed-rate euro denominated bonds as the hedged items and certain euro denominated interest rate swaps as the hedging instruments, whereby the Group pays floating rate interest and receives fixed rate interest. The hedging relationships are designated and accounted for as fair value hedges because the interest rate swaps are hedging the exposure of the Group to changes in the fair value of the bonds arising from changes in interest rates. The Group recognises the changes in the fair value of the interest rate swaps immediately in profit or loss together with the changes in the fair value of the bonds which are attributable to the interest rate risk. The changes in the clean fair value of the swaps and the notes are included in the line item “Net financial income (expense)”, the accrued interest on both the notes and the swaps is included in the line item “Interest expense” and foreign exchange gains and losses on the notes are included in the line item "Net foreign exchange gain (loss)".

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

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

72.6 Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash on hand, demand and term deposits with the Central Bank and with other credit institutions, short-term loans to credit institutions. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, that are subject to an insignificant risk of changes in their fair value and which are used by the Group in the management of its short-term cash commitments.

72.7 Investments in associates

Associates are entities over which the Group has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies. If the Group holds at least 20% of the voting power of an entity, or potential voting rights, it is presumed that the Group has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the Group holds less than 20% of the voting power of an entity, it is presumed that the Group does not have significant influence, unless such influence can be clearly demonstrated.

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. The carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets of the associate since the acquisition date. Goodwill relating to acquisitions of associates is included in the carrying amount of the investments and is not tested for impairment separately.

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases.

When the Group's share of losses of an associate 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 Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

72.7 Cont'd

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and the impairment loss is recognised in profit or loss.

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

Income and expenses from investments in associates are recognised in profit or loss in the line item "Other operating income".

72.8 Property and equipment

Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and impairment losses (see Note 72.21).

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

Subsequent costs

The Group 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 Group and the cost of the item can be measured reliably. All other costs are recognised in profit or loss as incurred.

Depreciation

Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. The depreciable amount of each item of property and equipment is determined after deducting its residual value. Depreciation is expensed in profit or loss 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
Equipment	4-5 years
Vehicles	3 years

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

72.9 Intangible assets

Software

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

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and impairment.

Subsequent expenditure on software assets 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.

Software is amortised on a straight-line basis in profit or loss over its estimated useful live, from the date that it is available for use. The estimated useful life of software is four to ten years.

Goodwill

The Group recognises any goodwill arising from a business combination as an asset and measures it initially at cost, being the positive difference between (a) the aggregate of the consideration transferred, the amount of any non-controlling interest and the acquisition-date fair value of the Group's previously held equity interest in the acquiree and (b) the net of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed by the Group.

After initial recognition, goodwill is measured at cost less any accumulated impairment losses. Goodwill is tested by the Group for impairment annually or whenever there is an indication that it may be impaired.

72.10 Leases

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

Group as a lessee
Lease payments under operating leases where the Group is the lessee are recognised as an expense on a straight-line basis over the capital lease term in the line item "Other operating expenses".

Group as a lessor
When the Group is the lessor in a capital lease, the Group recognises a receivable equal to the net investment in the lease and presents it in the line item "Loans to customers" in the statement of financial position. The Group applies its accounting policies for derecognition and impairment of financial assets also to its capital lease receivables. The Group recognises the finance income from capital lease receivables in profit or loss in the line item "Interest revenue" over the period of the capital lease so as to give a constant periodic rate of return on the net investment in the capital lease.

When the Group is lessor in arrangements which involve the legal form of capital leases, but which in substance do not involve leases, the Group classifies them within loans at amortised cost.

72.11 Non-current assets and disposal groups held for sale

Non-current assets and disposal groups are classified as held for sale and presented in separate line items in the statement of financial position if the Group 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 the initial classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable accounting policies. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets and investment properties, which are measured in accordance with the accounting policies of the Group applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment is no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Group applicable to those liabilities.

Income and expenses of non-current assets and disposal groups held for sale are recognised in profit or loss in the line item "Profit (loss) from discontinued operations, net of income tax" (see Note 72.24).

72.12 Loan commitments and financial guarantees

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. In 2017 the Group recognised a provision for loan commitments only when the Group was committed to providing a loan that would be considered to be impaired or when the commitment became onerous. From 1 January 2018, under IFRS 9, these contracts are in the scope of the ECL requirements (see Note 72.3). Expected credit loss of loan commitments is recognised in the statement of financial position in the line item "Other liabilities". Loan commitment fees received by the Group are recognised in profit or loss in the line item "Fee and commission income".

Financial guarantees are contracts that require the Group 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 issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities.

Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received. In 2017 the liabilities were subsequently carried at the higher of the amount representing the initial fair value amortised over the life of the guarantee and the best estimate of the expenditure required to settle the liability when a payment under the contracts had become probable. From 1 January 2018, under IFRS 9, the liabilities were subsequently carried at the higher of the amount representing the initial fair value amortised over the life of the guarantee and the ECL allowance (see Note 72.3).

Any changes in the liabilities arising from financial guarantees are recognised in profit or loss. The premium received is recognised in profit or loss in the line item "Fee and commission income".

72.13 Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group 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 reporting 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 the reimbursement will be received and the amount of the receivable can be measured reliably.

The Group recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

72.14 Employee benefits

All Group entities are required to pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid by the Group. The Group recognises these contributions as salary related expenses when they become due. The Group does not have a defined benefit pension plan.

Short-term employee benefits include salaries, short-term cash bonuses, social security contributions, short-term compensated absences and non-monetary benefits for current employees. Short-term employee benefit obligations are expensed by the Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

72.15 Equity

Share capital

The share capital disclosed in the consolidated financial statements represents the total nominal value of ordinary shares issued by the parent company. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

Dividends on shares

Dividends payable to shareholders of the parent company are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders at the parent company's annual general meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

Restricted reserves

The Group is to transfer, if applicable, certain amounts from retained earnings to restricted reserves which can therefore not be distributed as dividends to shareholders. These restricted reserves are specified as follows:

Restricted reserve due to capitalised development cost

When the Group capitalises development cost it transfers a corresponding amount from retained earnings to a restricted reserve. In the future the restricted amount is to be transferred back to retained earnings as the capitalised development cost is amortised in profit or loss.

Restricted reserve due to fair value changes of financial assets

The Group transfers fair value changes of financial assets at fair value through profit or loss, net of tax if applicable, from retained earnings to a restricted reserve. Amounts recognised in the reserve are transferred back to retained earnings upon sale of the financial asset.

Restricted reserve due to unrealised profit of subsidiaries and associates

If share of profit of a subsidiary or an associated company is in excess of dividend received or which can be claimed, the Group transfers the difference to a restricted reserve in equity. If the Group's shareholding in a subsidiary or an associate is sold or written off the applicable amount recognised in the reserve is transferred to retained earnings.

Notes to the Consolidated Financial Statements

72.15 Cont'd

Fair value reserve

Fair value reserve comprises all unrealised gains or losses related to fair value changes of equity instruments classified at fair value through other comprehensive income. On derecognition of the equity instruments fair value changes are not reclassified to profit and loss.

Liability credit reserve

Changes in fair value attributable to changes in the credit risk of financial liabilities designated as at fair value through profit or loss are recognised in other comprehensive income and are not subsequently reclassified to profit or loss.

Other reserves

Other reserves consist of statutory reserve and translation reserve.

Statutory reserve

According to the Act on Public Limited Companies no. 2/1995 the statutory reserve shall amount to 25% of the share capital of the Bank.

Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

72.16 Interest income and interest expense

For all financial assets and financial liabilities measured at amortised cost, interest income and interest expense is recognised in profit or loss using the effective interest method. For financial assets and financial liabilities at fair value through profit and loss, interest income and interest expense is recognised through profit or loss on an accrual basis, except for financial liabilities at fair value through profit or loss (see Note 72.3).

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro denominated bonds issued by the Group (see Note 72.5), is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

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 Group 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 Group 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 interest expense. For floating rate instruments, interest income or interest 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. For financial assets in Stage 1 and Stage 2 interest is recognised on the gross carrying amount of the assets and for financial assets in Stage 3 interest is recognised on the gross carrying amount of the assets, net of impairment allowance (see Note 72.3).

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

72.17 Net fee and commission income

Fees and commissions are recognised to reflect the transfer of services to customers at an amount that reflects the consideration that is expected to be received for such services. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or financial liability are included in the measurement of the effective interest rate.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised in profit or loss on a straight-line basis over the commitment period.

72.17 Cont'd

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Group 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 is fulfilled.

Where it is assessed that the Group is acting as an agent, the consideration is presented on a net basis.

72.18 Net financial income (expense)

Net financial income (expense) consists of net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss, net gain (loss) on financial liabilities designated as at fair value through profit or loss and net gain (loss) on fair value hedges.

Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss
Net gain (loss) on financial assets and financial liabilities mandatorily at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets and financial liabilities classified by the Group as mandatorily at fair value through profit or loss, except for interest income and interest expense, which are included in the line items "Interest income" and "Interest expense", and foreign exchange gains and losses, which are included in the line item "Net foreign exchange gain (loss)". Dividend income from financial assets is recognised in the income statement when the Group's right to receive payment is established.

Net gain (loss) on financial liabilities designated as at fair value through profit or loss
Net gain (loss) on financial liabilities designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial liabilities designated by the Group as at fair value through profit or loss, except for changes in fair value attributable to changes in credit risk which is recognised in other comprehensive income, interest incurred which is recognised as "Interest expense" on an accrual basis, and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

Net gain (loss) on fair value hedges
Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are designated and accounted for as hedging instruments in fair value hedges and the changes in the fair value of certain bonds issued by the Group, which are attributable to the interest rate risk of the bonds (see Note 72.5).

72.19 Net foreign exchange gain (loss)

Net foreign exchange gain (loss) disclosed as a separate line item in the income statement comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the year or in previous financial statements.

Net foreign exchange gain (loss) also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured by the Group at fair value in foreign currencies.

72.20 Operating expenses

Operating expenses consist of professional services, depreciation of property and equipment, amortisation of intangible assets and other operating expenses, such as housing costs, advertising expenses and information system related expenses.

72.21 Impairment of non-financial assets

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

An impairment loss is recognised in profit or loss if the carrying amount of an asset or cash-generating unit exceeds its estimated recoverable amount.

An impairment loss for non-financial assets 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.

72.22 Bank tax

Bank tax is a tax on credit institutions which stated purpose is to create revenue for the Icelandic Government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, the tax is intended as a deterrent to increased risk appetite. The Bank tax is 0.376% of total liabilities in excess of ISK 50,000 million and is shown in a separate line in the income statement.

72.23 Income tax

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations. Income tax from discontinued operations is included in the line item "Profit (loss) from discontinued operations, net of income tax" in the income statement (see Note 72.24).

Income tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the Group recognises it in other comprehensive income or directly in equity, consistent with the recognition of the underlying item to which it relates.

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

Deferred tax is calculated based on temporary differences between the carrying amounts of assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration any tax loss carry forwards. 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 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. A deferred tax asset is reduced to the extent that it is no longer probable that the related tax benefit will be realised.

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

Tax assets are included in the line item "Other assets" and deferred tax liabilities are included in the line item "Tax liabilities" in the statement of financial position. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 72.11) are included in the line items "Non-current assets and disposal groups held for sale" and "Non-current liabilities and disposal groups held for sale", respectively, in the statement of financial position.

Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

72.24 Profit (loss) from discontinued operations

The profit or loss from discontinued operations consists of (i) the post-tax profit or loss from discontinued operations, (ii) loss recognised on the measurement to fair value less costs to sell in excess of book value of discontinued operations, (iii) profit or loss on the disposal of discontinued operations and (iv) the post-tax profit or loss from the sale of foreclosed assets held for sale.

72.25 Offsetting income and expenses

The Group presents income and expenses on a net basis in the income statement only when required or permitted under IFRSs.

72.26 Earnings per share

The Group presents basic and diluted earnings per share (EPS) for its ordinary shares. Basic EPS are calculated by dividing the profit or loss attributable to ordinary shareholders of the Group by the weighted average number of ordinary shares outstanding during the period. Diluted EPS are determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

72.27 Segment reporting

An operating segment is a distinguishable component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segment is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. The segment profit presented is the profit reported to the chief operating decision maker (CEO) and the Board of Directors for the purpose of resource allocation and assessment of segment performance.

Íslandsbanki's Corporate Governance Statement 2018

Unaudited

Unaudited Appendix: Corporate Governance Statement 2018

The Board of Directors of Íslandsbanki is committed to excellence in corporate governance complying with the applicable regulatory standards and best international practices in the field of corporate governance.

Íslandsbanki's governance practises are consistent with general corporate governance guidelines for entities regulated by official supervisors and regulatory instruments. The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable law and regulations, including those imposed by the FME and Nasdaq Iceland, available at their respective websites (www.fme.is and www.nasdaqomxnordic.com). The applicable law includes, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Competition no. 44/2005 and the Act on Public Limited Companies no. 2/1995, which along with the Íslandsbanki's Articles of Association lay the foundation for the Bank's existence and activities. The relevant law is available on the Icelandic legislature's website (www.althingi.is).

Exemplary in Corporate Governance

Íslandsbanki is committed to maintaining high standards of governance complying with best governance practices. Íslandsbanki was first recognised as "Exemplary in Corporate Governance" in March 2014 by the Centre of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in 2015, 2016, 2017 and 2018.

Íslandsbanki maintains a Good Governance Policy and Matrix for material bank actions, which outlines all major decisions the Bank may wish to take under given circumstances. The policy is a part of the Bank's effort to improve its material actions and enhance stakeholders' trust. The Matrix for material bank actions sets specific conditions to all major decision-making and requires that all such decisions be taken after consultation with the relevant parties within the Bank and on the basis of the best information available at the time.

Compliance with Corporate Governance Guidelines

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland (hereinafter the Guidelines), in accordance with Paragraph 7 of Article 54 of the Act on Financial Undertakings no. 161/2002. The Guidelines are available on www.corporategovernance.is. Governance practices of the Bank are consistent with the Guidelines. Íslandsbanki is in full compliance with them except for Article 1.5. In accordance with Article 1.5 of the Guidelines the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee while the Icelandic Government (ISFI) is the sole owner of the Bank. Board members are nominated by the ISFI through a selection process administered by the Icelandic State Financial Investments (ISFI) in accordance with article 7 of Act no. 88/2009 on the Icelandic State Financial Investments.

Main aspects of Risk Management and Internal Control

Internal Control

The risk management and internal control framework of the Bank is based on the three-lines-of-defence model, as referred to in the European Banking Authority's Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness throughout the Bank. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Bank's internal rules.

The first line of defence consists of the Bank's business and support units; the second line of defence is comprised of the Bank's internal control units, Risk Management and Compliance; and the third line of defence is Group Internal Audit which keeps the Board and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Risk Management

The Board of Directors approves the risk policy, risk appetite statement and procedure for risk management and ensures that internal procedures for risk management are revised at least annually.

The All Risk Committee, a Senior Management Committee, is comprised of the CEO, all the managing directors of the Bank and other members of management appointed by the CEO. The committee is responsible for the review and implementation of the risk management and internal control policies issued by the Board and monitors that the risk profile of the Bank is within the limits of the risk appetite statement of the Board of Directors. The ARC issues guidelines for risk assessment and individual risk thresholds or limits in accordance with Board approved risk appetite.

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Further information on the Bank's risk management structure and internal control can be found in the Bank's Pillar 3 Report which is published on the Bank's website.

Audit and accounting

The CEO ensures that Directors of the Board are provided with accurate information on the Bank's finances, development and operations on a regular basis and the Board Audit Committee assists the Board in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control, the audit process.

The Bank's Finance division is responsible for the preparation of the Bank's consolidated financial statements in line with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions. The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review the second quarter consolidated financial statements and audit the annual consolidated financial statements.

The consolidated financial statements are published on an annual and quarterly basis.

As is provided for in the Act on Financial Undertakings and the Bank's Articles of Association, the Bank's external audit firm is elected at the AGM. At the 2016 AGM the Icelandic National Audit Office (INAO) was elected, for the first time, to serve as Íslandsbanki's independent external auditing firm, in accordance with Article 4 of Act no. 46/2016 on the Auditor General and the auditing of government accounts for a term of five years. The INAO has concluded an agreement and trusting Ernst & Young with carrying out the Bank's external audit on its behalf.

Group Internal Audit

The Chief Audit Executive is appointed by the Board, reports directly to the Board and directs Group Internal Audit with a mandate from the Board. Group Internal Audit operates independently from other departments in accordance with Article 16 of the Act on Financial Undertakings no. 161/2002. The department provides the Board with independent and objective assurance over the effectiveness of risk management, control and governance processes. The Chief Audit Executive is engaged by the Board and is responsible for internal audit on a group basis. The responsibilities and authorisations of the CAE and Group Internal Audit are further outlined in the Group Internal Audit Charter.

Compliance

The Bank's Compliance Officer is hired by the CEO, subject to Board confirmation, conferring the department's mandate. The Compliance officer maintains an independent position within the Bank's organisation and is responsible for monitoring and assessing regularly whether the Bank's operations, regarding securities transactions, are in compliance with applicable law. Furthermore, the Compliance Officer is responsible for assessing and monitoring the Bank's compliance with Act on Measures against Money Laundering and Terrorist Financing no. 64/2006 and the Bank's responsible officer under the US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard (CRS). Moreover, the Compliance Officer is responsible for supervision of compliance risk within the Bank.

Íslandsbanki Values, Code of Conduct and Social Responsibility

Íslandsbanki's values are the pillars of the Bank's corporate culture, shaping the conduct and attitudes of its employees. The values insist on employees being professional, disciplined in their working procedures, and following matters through – professional, positive and progressive.

In order to maintain and strengthen the credibility and the reputation of the Bank, the Board has approved a Code of Conduct for the Bank's employees which is available on the Bank's website. The aim of the code is to promote good operational and business practices, increase trust and guide employees in their daily work.

Íslandsbanki seeks to work in harmony with the communities in which it operates and strives to have a positive impact in society. This participation in community programmes rests on Íslandsbanki's Corporate Social Responsibility Strategy which is set by the Board. The strategy covers five key areas: business, education, environment, workplace, and community. Furthermore, the Bank produces an annual report, Íslandsbanki in the Community: Global Compact, which can be accessed on the Bank's website. For the last eight years Íslandsbanki has been a signatory to the UN Global Compact on social responsibility. The compact is a guide for companies on how to be socially responsible in practice.

Unaudited Appendix: Corporate Governance Statement 2018

Board of Directors

The Board of Directors comprises seven non-executive directors, and two alternates, elected at each AGM for a term of one year. The Chairman of the Board is elected by the shareholders' meeting. There are no limitations on duration of Board membership.

The Board undertakes the Bank's affairs in between shareholders' meetings unless otherwise provided by law or the Bank's Articles of Association. The Board is responsible for setting the Bank's general strategy and instructs the CEO on its further implementation and execution. The Board has a supervisory role in that it oversees that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations and good business practices. The CEO and Chief Audit Executive are hired by the Board.

The Rules of Procedure of the Board are adopted in accordance with Article 70 of the Act on Public Limited Companies no. 2/1995 and Article 54 of the Act on Financial Undertakings no. 161/2002. The Board's current rules of Procedure, adopted on 22 August 2018, are available on the Bank's website. According to its Rules of Procedure, at meetings of the Board the presence of at least five members of the Board is required to constitute a quorum. The Board met 20 times in 2018, each time constituting a quorum.

Candidates for board membership are nominated through a selection process administered by ISFI in accordance with Article 7 of Act no. 88/2009 on Icelandic State Financial Investment. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currently the Board is comprised of four women and three men. The Board has approved a policy on the suitability of the Board of Directors, the CEO and key function holders. The policy states, among other things, that the composition of the Board shall at any time be diversed, with regard to educational and professional background, gender and age.

The Board subcommittees

The Boards subcommittees are three in total and they operate under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of the Board subcommittees are available on the Bank's website. The Board appoints the members of the subcommittees as well as their Chairman. When appointing the subcommittees the Board shall take into account the expertise, skills and experience needed of a member to be appointed to the relevant subcommittee. All of the subcommittees are constitued of members of the Board.

The Board Audit Committee**,** comprising three Board members, assists the Board in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control, the audit process and the Bank's process for monitoring compliance with the relevant laws and regulations and its code of conduct. The committee met 9 times in 2018, each time constituting a quorum.

The Board Risk Management Committee, comprising three Board members, assists the Board in providing oversight of senior management activities in managing risk relevant to the Bank's operations. This includes credit risk, market risk, operational risk, liquidity risk, compliance risk and reputational risk. The committee met 9 times in 2018, each time constituting a quorum.

The Board Corporate Governance, Compensation and Human Resource Committee**,** comprising three Board members, assists the Board in overseeing the development and the regular assessment of the Bank's approach to corporate governance issues and board effectiveness. Furthermore it is responsible for providing oversight regarding compensation and human resource issues. The committee met 8 times in 2018, each time constituting a quorum.

Structure and composition of Board subcommittees is as follows:

	Board Corporate Governance, Compensation and HR Committee	Audit Committee	Board Risk Management Committee
Friðrik Sophusson	Member		
Anna Þórðardóttir		Chair	
Auður Finnbogadóttir			Member
Árni Stefánsson			Member
Hallgrímur Snorrason	Member	Member	
Heiðrún Jónsdóttir	Chair	Member	
Helga Valfells			Chair

Chair Member

Unaudited Appendix: Corporate Governance Statement 2018

Members of the Board

Friðrik Sophusson, Chairman of the Board, (b. 1943), joined the Board in January 2010. Friðrik has comprehensive experience in fiscal policy-making, management, and public service in Iceland. He has also served on the board of several companies and institutions. He was Managing Director of the Icelandic Management Association from 1972 until 1978, when he was elected to Parliament. During his tenure as an MP, he held the position of Minister of Industry and Energy in 1987-1988 and Minister of Finance in 1991-1998. He was appointed CEO of Landsvirkjun, the National Power Company of Iceland, in 1999 and held that position for almost 11 years. He serves as chairman of the board of Hlíðarendi, a private non-profit institution.

Friðrik holds a Cand. Jur. from the University of Iceland.

Sub-Committees: Member of the Board Corporate Governance, Compensation and Human Resource Committee.

Anna Þórðardóttir (b. 1960) joined the Board in April 2016. She has been a board member of a number of companies and organisations, including KPMG and the Institute of State Authorised Public Accountants in Iceland. She is currently a member of the board of The Icelandic Center for Future Studies (Framtíðarsetur Íslands) and Heimavellir and is chairman of the Board Audit Committee of Hagar. Anna was an employee of KPMG in 1988-2015, where she became partner in 1999. While at KPMG, she was responsible for the audit of the following companies: Reitir, Hagar, 365, Baugur Group, Vodafone, Landfestar, Landey, 10-11 and Félagsbústaðir.

Anna holds a Cand Oecon. in Business Administration from the University of Iceland and is a Chartered Accountant. She has also studied towards a Cand. Merc in Financial studies from Handelhøjskolen in Aarhus, Denmark.

Sub-Committees: Chairman of the Board Audit Committee.

Auður Finnbogadóttir (b. 1967) joined the Board in April 2016. She is a project manager of strategy at Kopavogur municipality. She has extensive experience of working in the financial markets and has served on the board of several companies and institutions. She was Managing Director for MP Bank, Lífsverk pension fund and the pension fund for employees of Kópavogur municipality. She has served as chairman of the board of the Competition Authority in Iceland and Norðlenska ltd., a production and marketing firm for agricultural products. She has been a member of the board of the Iceland Enterprise Investment Fund, Icelandair Group, Nýi Kaupþing banki, RÚV, the Icelandic National Broadcasting service and Landsnet, the electric transmission grid company of Iceland. She serves as an alternate member of a governmental committee, the Procurement Complaints Committee.

Auður holds a B.Sc. in International Business from the University of Colorado at Boulder and an MBA from Reykjavík University. She completed a diploma program in Public Administration in spring 2018 and is a licensed securities broker by the Icelandic Ministry of Finance and Economic Affairs.

Sub-Committees: Member of the Board Risk Management Committee.

Árni Stefánsson (b. 1966) joined the Board in April 2016. He has extensive management experience in power-intensive industry in Iceland and is currently manager and member of the executive board at the Rio Tinto primary aluminium plant. Previously, he was a manager and member of the board of directors of the Century Aluminium plant Norðurál in Grundartangi; manager and vice-president with Landsnet, the electric transmission grid company of Iceland; and manager with Landsvirkjun, the National Power Company of Iceland.

Árni holds an M.Sc. and B.Sc. in electrical engineering from Aalborg University in Denmark.

Sub-Committees: Member of the Board Risk Management Committee.

Hallgrímur Snorrason (b. 1947) joined the Board in April 2016. An independent consultant in official statistics, he was Director-General of Statistics Iceland in 1985-2007 and Deputy Managing Director of the National Economic Institute of Iceland in 1980-1984. Has been a member of the board of several companies, including Útvegsbanki Íslands, Skýrr and Auður Capital. He has also chaired or served on a number of governmental committees, both domestically and in connection with Nordic cooperation, EFTA, EU and the OECD.

Hallgrímur holds a M.Sc. in Economics from the University of Lund in Sweden and a B.Sc. in Economics from the University of Edinburgh.

Sub-Committees: Member of the Board Corporate Governance, Compensation and Human Resource Committee and the Board Audit Committee.

Heiðrún Jónsdóttir (b. 1969) joined the Board in April 2016. She is an attorney at law with Múli Legal Services and serves as a member of the board of Icelandair Group and the deputy chairman of the board of the Icelandic Bar Association. Previously, she was Managing Director at Eimskipafélag Íslands, Lex Legal Services, and Legal and Human Resources at KEA. She has been chairman of the board at Norðlenska, Íslensk Verðbréf and Gildi pension fund and has been a member of the board of the Icelandic Banks' Data Centre (RB), Ístak, the securities depository Arion Verðbréfavarsla, Þekking, the Icelandic Pension Funds Association, Síminn and Olíuverzlun Íslands.

Heiðrún holds a Cand. Jur from the University of Iceland and is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs. She completed an Advanced Management Program (AMP) at IESE Business School in Barcelona in 2017.

Sub-Committees: Chairman of the Board Corporate Governance, Compensation and Human Resource Committee and a member of the Board Audit Committee.

Helga Valfells (b. 1964) joined the Board in September 2013. Helga is one of the founders of the Icelandic venture firm Crowberry Capital, where she currently serves as CEO. Previous employers include Estée Lauder UK, Merrill Lynch Europe, and the Trade Council of Iceland, where she worked with a number of export companies. Helga was a director of NSA Ventures in 2010-2016. During her tenure with the Fund, she sat on 14 start-up boards. An active entrepreneur, she has participated in founding start-up companies and previously acted as an advisor to the Icelandic Minister of Business Affairs. Furthermore, she has worked as an independent consultant for a number of export companies from Iceland, the UK, and Canada. She is an alternate board member of FSÍ (Framtakssjóður Ísl) GP.

Helga holds a B.A. from Harvard University and an MBA from London Business School.

Sub-Committees: Chairman of the Board Risk Management Committee.

Alternate members of the Board are two; Herdís Gunnarsdóttir and Pálmi Kristinsson, both since April 2016.

All members of the Board are considered independent from the Bank, its main clients, competitors and shareholder.

Board Performance and Suitability Assessment

At least once a year, as provided for in the Board's Rules of Procedure, the Board assesses its work, procedures and practices as well as each of its members. This performance assessment is intended to improve working methods and increase the efficiency of the Board. The assessment entails an evaluation of the strengths and weaknesses of the Board's work and practices. This is i.a. based on an assessment of the necessary number of board directors, the board structure in relation to knowledge and experience, board procedure and practices. This assessment was last performed by the Board in January 2019.

Furthermore, the Board annually assesses the collective suitability of the Board and individual Board members in accordance with the Board’s Rules of Procedure and the Bank's policy on the assesment of the suitability of the Board of Directors, the CEO and key function holders.

The Chief Executive Officer

The Chief Executive Officer (CEO) is responsible for the day-to-day operations of the Bank and that the Bank's business is, at all times, in accordance with the Bank's Articles of Association, policies of the Board and the relevant law. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Committee and other Senior Management Committees.

Birna Einarsdóttir (b. 1961) is the CEO of Íslandsbanki. She holds a Cand. Oecon. in Business Administration from the University of Iceland and an MBA from the University of Edinburgh. Birna has been with Íslandsbanki and its predecessors in various divisions for over 20 years and CEO since 15 October 2008. Previous to that she was a Senior Product Managerat the Royal Bank of Scotland and marketing manager for the Icelandic Broadcasting Company Stöð 2 (Channel 2) and Íslensk getspá. Birna is considered independent from the Bank, its main clients, competitors and shareholder.

The executive committee

The executive committee consists of seven people, including the CEO: Birna Einarsdóttir, CEO since October 2008, Jón Guðni Ómarsson, Chief Financial Officer since October 2011, Sigríður Hrefna Hrafnkelsdóttir, Managing Director of Personal Banking since May 2017, Sigríður Olgeirsdóttir, Chief Operating Officer since September 2010, Guðmundur Kristinn Birgisson, Chief Risk Officer since October 2018, Una Steinsdóttir, Managing Director of Business Banking since May 2017 and, Ásmundur Tryggvason Managing Director of Corporate & Investment Banking since January 2019. Ásmundur succeeded Vilhelm Már Þorsteinsson, who served the position from May 2017.

Unaudited Appendix: Corporate Governance Statement 2018

Senior Management Committees

Senior Management Committees are advisory committees appointed by the CEO. Senior Management Committees are divided into Executive Committees and Business Committees. The committees are appointed by the CEO, and their letters of mandate and rules of procedure are documented in a charter set by the CEO and presented to the Board.

The Executive Committees: The Executive Committee and the All Risk Committee are responsible for the implementation of the Board approved business strategy, risk appetite and policies and consist of the CEO, all managing directors as well as other members of senior management appointed by the CEO.

Business Committees: The Asset and Liability Committee, the Senior Credit Committee, the Investment Committee, the Operational and Security Committee, are responsible for the approval of business proposals and their operational framework and implementation subject to internal rules and guidelines issued by the All Risk Committee and the Board.

The Executive Committee, chaired by the CEO, is responsible for implementing the Board approved business strategy.

The All Risk Committee is responsible for the review and implementation of the risk management and internal control policies issued by the Board and monitors that the risk profile of the Bank is within the limits of the risk appetite statement of the Board of Directors.

The Business Committees decide on individual business proposals in accordance with the rules and procedures issued by the All Risk Committee and the Board.

The Senior Credit Committee decides on proposals on lending and is the formal venue for discussion and review of individual loan proposals.

The Asset and Liability Committee decides on proposals regarding market risk, liquidity risk, funding, capital and internal and external pricing.

The Investment Committee decides on proposals regarding the purchase, sale and valuation of equity stakes and other investments of the Bank.

The Operational and Security Committee decides on proposals regarding new products and services, continuous operation and material changes in systems and procedures.

Arrangement of communications between shareholders and the Board

The Board communicates with shareholders in accordance with the relevant laws, the Bank's Articles of Association and the Board's Rules of Procedure. Members of the Board of Directors shall, in their duties and decision-making, safeguard the interests of the Bank and its shareholders in accordance with the applicable law, rules, regulations and guidelines.

The Bank is wholly owned by the Icelandic Government since January 2016, directly and through ISB Holding, which is also wholly owned by the Icelandic Government. The shares are administered by Icelandic State Financial Investments (ISFI) in accordance with the Act on Icelandic State Financial Investments no. 88/2009. Shareholders' meetings, the supreme authority of the Bank, are the general forum for informing and communicating with shareholders. Following each publishing of financial results of the Bank a meeting is held with the ISFI to present the relevant financial results. In between meetings of the Bank's shareholders the Chairman of the Board, on behalf of the Board of directors, is responsible for communications with shareholders.

Information on infringements of laws and regulations that the appropriate supervisory or ruling body has determined.

In its decision no. 4/2018 the Consumer Agency of Iceland came to the conclusion that by advertising in the form of social media entries Íslandsbanki violated paragraphs 1 and 2 of Article 6 of Act no. 57/2005, on business practices and marketing. The violation did, however, not result in a fine being imposed. Information on legal cases relating to Íslandsbanki can be found in the notes to the consolidated financial statements.

This Corporate Governance Statement was approved by Íslandsbanki’s Board of Directors on 13 February 2019.