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Directors' Report

The condensed consolidated interim financial statements for the first half of 2018 ("the interim financial statements") comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries (together referred to as "the Group").

Operations in the reporting period

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 profit from the Group's operations for the reporting period amounted to ISK 7,130 million, which corresponds to 8.2% annualised return on equity. At the end of the reporting period, the Group employed 1,013 full-time members of staff, including 826 within the Bank itself.

Net interest income was close to being flat between years, as strong balance sheet growth was offset by a lower interest rate environment. Net fee income was down by 15%, where good performance in the Bank was offset by reduced activity in Borgun and Hringur, subsidiaries of the Bank. Other operating income totalled 1,600 million which was predominately driven by the sale of one of the Bank's subsidiaries. Salary costs were up by 2.4% 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 FTE's. Other operating expenses grew by 4.9% between years.

Net impairments were positive by ISK 1,934 million. During the period, the statute of limitation for some disputed foreign currency-linked loan contracts passed resulting in a release of ISK 1.011 million provision in the income statement, see note 39 for further information. The loan book continues to perform well resulting in positive net impairment together with the continuous development of IFRS 9 which had positive effects during the period.

Profit from discontinued operations amounted to ISK 794 million, mainly resulting from the sale of listed equities from a subsidiary of the Bank.

The Group's balance sheet grew by 7.3% in the first half of 2018 on the back of a 5.9% growth in loans to customers and considerable growth in liquid assets. Although economic growth is slowing down in Iceland, demand for new loans continues to be very strong in all customer segments. Following the implementation of IFRS 9 a new standard measure for non-performing loans (NPL's) has not been fully established internationally. At this time it is therefore difficult to compare the quality of the Bank's loan book to other banks and to analyse the historical development. However, the European Banking Authority (EBA) has published their measure of NPL's as the ratio of the gross carrying amount of loans and advances in Stage 3 as a proportion of the total gross carrying amount of loans and advances. At the end of the reporting period this ratio was 2.3% for the Group as compared to 3.9% weighted average for European banks at the end of March 2018.

Customer deposits increased by 2.0% during the first half of 2018 and the customer deposit-to-loan ratio was 72.3% at the end of the period. The main increase in deposits came from individuals.

Conditions in global credit markets continued to be volatile in the second quarter, inspired by a bearish rate environment in the major economies of the world and geo-political risks adding to uncertainty. Bond yields have gone up in the secondary markets in general and for the Icelandic banks this meant some 30 basis points increase in expected funding costs. The Bank has, however, continued to have good access to funding markets and issued ISK 60 billion in foreign currency debt and ISK 13 billion in covered bonds in the domestic market in the first half of the year.

The Group's total equity amounted to ISK 172.2 billion and total assets were ISK 1,111.7 billion at the end of the reporting period and the Group's total capital ratio was 21.6%, above the 19.8% regulatory requirement. 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. The Bank's liquidity position remains strong and well above regulatory requirements.

Outlook

Growth in the Icelandic economy is moderating, mainly on the back of slower growth in tourism. At the same time, inflation is at about the Central Bank target of 2.5% and annual growth in house prices has slowed to 5.2% in June, down from double digit numbers in the past 2-3 years. While the Icelandic stock market index (OMX18) grew by 5% in the first half of the year, earnings for listed companies have been in many cases lower than expected.

The outlook for the Bank continues to be fairly favourable, with moderate economic growth and more balanced domestic operating environment, where asset prices are expected to rise at a slower pace going forward and growth in economic activity will rely less on a single industry.

Directors' Report

Statement by the Board of Directors and the CEO

The interim financial statements for the period 1 January to 30 June 2018 have been prepared on a going concern basis in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting 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 best of our knowledge, these interim financial statements provide a true and fair view of the Group's operating profits and cash flows in the reporting period and its financial position as of 30 June 2018.

The Board of Directors and the CEO have today discussed and approved the Condensed Consolidated Interim Financial Statements for the period 1 January to 30 June 2018.

Kópavogur, 2 August 2018

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

Report on Review of Condensed Consolidated Interim Financial Statements

To the Board of Directors and Shareholders of Íslandsbanki hf.

We have reviewed the accompanying Condensed Consolidated Interim Financial Statements of Íslandsbanki hf. and its subsidiaries as at 30 June 2018 which comprise of the Consolidated Interim Statement of Financial Position as at 30 June 2018 and the related Consolidated Interim Income Statement, the Consolidated Interim Statement of Comprehensive Income, the Consolidated Interim Statement of Changes in Equity and Consolidated Interim Statement of Cash Flows for the six months ended 30 June 2018 and explanatory notes. The Board of Directors and CEO are responsible for the preparation and fair presentation of these Condensed Consolidated Interim Financial Statements in accordance with the International Financial Reporting Standard, IAS 34 Interim Financial Reporting as adopted by the EU. Our responsibility is to express a conclusion on these Condensed Consolidated Interim Financial Statements based on our review.

Scope of Review

We conducted our review in accordance with the International Standard on Review Engagements 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity. A review of interim financial statements consists of making inquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with International Standards on Auditing and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Conclusion

Based on our review nothing has come to our attention that causes us to believe that the accompanying Condensed Consolidated Interim Financial Statements are not prepared, in all material respects, in accordance with the International Financial Reporting Standard, IAS 34 Interim Financial Reporting, as adopted by the EU.

Reykjavík, 2 August 2018

Ernst & Young ehf.

Margrét Pétursdóttir
State Authorised Public Accountant

Consolidated Interim Income Statement

| | Notes | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|---|-------|------------------|------------------|------------------|------------------|
| Interest income | | 29,337 | 28,619 | 14,342 | 14,767 |
| Interest expense | | (13,995) | (13,408) | (6,740) | (6,953) |
| Net interest income | 10 | 15,342 | 15,211 | 7,602 | 7,814 |
| Fee and commission income | | 9,236 | 10,526 | 4,963 | 5,397 |
| Fee and commission expense | | (3,426) | (3,713) | (1,931) | (1,854) |
| Net fee and commission income | 11 | 5,810 | 6,813 | 3,032 | 3,543 |
| Net financial income | 12 | 95 | 109 | 378 | 97 |
| Net foreign exchange (loss) gain | 13 | (67) | 370 | (57) | 169 |
| Other operating income | 14 | 1,600 | 215 | 1,587 | 55 |
| Other net operating income | | 1,628 | 694 | 1,908 | 321 |
| Total operating income | | 22,780 | 22,718 | 12,542 | 11,678 |
| Salaries and related expenses | 15 | (7,952) | (7,768) | (4,026) | (4,109) |
| Other operating expenses | 16 | (5,770) | (5,498) | (2,846) | (2,739) |
| Contribution to the Depositors' and Investors' Guarantee Fund | | (579) | (515) | (287) | (262) |
| Bank tax | | (1,597) | (1,472) | (812) | (752) |
| Total operating expenses | | (15,898) | (15,253) | (7,971) | (7,862) |
| Profit before net impairment on financial assets | | 6,882 | 7,465 | 4,571 | 3,816 |
| Net impairment on financial assets | 17 | 1,934 | 440 | 1,846 | 200 |
| Profit before tax | | 8,816 | 7,905 | 6,417 | 4,016 |
| Income tax expense | 18 | (2,480) | (2,263) | (1,465) | (1,133) |
| Profit for the period from continuing operations | | 6,336 | 5,642 | 4,952 | 2,883 |
| Profit from discontinued operations, net of income tax | 19 | 794 | 2,399 | 81 | 2,114 |
| Profit for the period | | 7,130 | 8,041 | 5,033 | 4,997 |
| Profit attributable to: | | | | | |
| Shareholders of Íslandsbanki hf. | | 7,321 | 8,384 | 5,135 | 5,429 |
| Non-controlling interests | | (191) | (343) | (102) | (432) |
| Profit for the period | | 7,130 | 8,041 | 5,033 | 4,997 |
| Earnings per share from continuing operations | | | | | |
| Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf. | 20 | 0.65 | 0.60 | 0.51 | 0.33 |

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

The notes on pages 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Consolidated Interim Statement of Comprehensive Income

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|--|------------------|------------------|------------------|------------------|
| Profit for the period | 7,130 | 8,041 | 5,033 | 4,997 |
| Items that are or will be reclassified to profit or loss: | | | | |
| Foreign currency translation differences for foreign operations | - | 9 | - | 4 |
| Items that will not be reclassified to profit or loss: | | | | |
| Changes in fair value of financial assets and financial liabilities, net of tax .. | 1,114 | 82 | 812 | (114) |
| Other comprehensive income for the period, net of tax | 1,114 | 91 | 812 | (110) |
| Total comprehensive income for the period | 8,244 | 8,132 | 5,845 | 4,887 |

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

The notes on pages 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Consolidated Interim Statement of Financial Position

| | Notes | 30.6.2018 | 31.12.2017 |
|--|-------|------------------|------------------|
| Assets | | | |
| Cash and balances with Central Bank | 21 | 166,194 | 189,045 |
| Bonds and debt instruments | 5 | 48,603 | 27,090 |
| Shares and equity instruments | 5 | 13,581 | 10,177 |
| Derivatives | 22 | 3,209 | 2,896 |
| Loans to credit institutions | 23 | 59,858 | 26,617 |
| Loans to customers | 24 | 799,938 | 755,175 |
| Investments in associates | 26 | 614 | 704 |
| Property and equipment | | 5,058 | 7,128 |
| Intangible assets | | 4,774 | 4,231 |
| Other assets | 28 | 8,512 | 9,993 |
| Non-current assets and disposal groups held for sale | 29 | 1,401 | 2,766 |
| Total Assets | | 1,111,742 | 1,035,822 |
| Liabilities | | | |
| Deposits from Central Bank and credit institutions | 30 | 15,391 | 11,189 |
| Deposits from customers | 31 | 578,414 | 567,029 |
| Derivative instruments and short positions | 22 | 7,075 | 5,492 |
| Debt issued and other borrowed funds | 33 | 288,360 | 217,748 |
| Subordinated loans | 34 | 8,872 | 9,505 |
| Tax liabilities | | 8,925 | 7,787 |
| Other liabilities | 36 | 32,447 | 35,947 |
| Non-current liabilities and disposal groups held for sale | | 76 | 80 |
| Total Liabilities | | 939,560 | 854,777 |
| Equity | | | |
| Share capital | | 10,000 | 10,000 |
| Share premium | | 55,000 | 55,000 |
| Reserves | | 5,598 | 6,179 |
| Retained earnings | | 99,159 | 107,387 |
| Total equity attributable to the equity holders of Íslandsbanki hf. | | 169,757 | 178,566 |
| Non-controlling interests | | 2,425 | 2,479 |
| Total Equity | | 172,182 | 181,045 |
| Total Liabilities and Equity | | 1,111,742 | 1,035,822 |

The notes on pages 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Consolidated Interim 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 period | | | | | | | 8,384 | 8,384 | (343) | 8,041 |
| Dividends paid | | | | | | | (10,000) | (10,000) | (1,315) | (11,315) |
| Net change in fair value of AFS financial assets | | | | 53 | | | | 53 | 29 | 82 |
| Translation differences for foreign operations | | | | | | 9 | | 9 | | 9 |
| Changes in non-controlling interests | | | | | | | | - | 186 | 186 |
| Restricted due to capitalised development cost | | | 807 | | | | (807) | - | | - |
| Restricted due to fair value changes | | | 134 | | | | (134) | - | | - |
| Restricted due to subsidiaries and associates | | | 570 | | | | (570) | - | | - |
| Equity as at 30.6.2017 | 10,000 | 55,000 | 3,184 | 28 | - | 2,500 | 102,436 | 173,148 | 2,780 | 175,928 |
| 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 period | | | | | | | 7,321 | 7,321 | (191) | 7,130 |
| Dividends paid | | | | | | | (13,000) | (13,000) | | (13,000) |
| Net change in fair value of financial assets through OCI | | | | 227 | | | | 227 | 131 | 358 |
| Net change in fair value of financial liabilities | | | | | 756 | | | 756 | | 756 |
| Restricted due to capitalised development cost | | | 325 | | | | (325) | - | | - |
| Restricted due to fair value changes | | | (71) | | | | 71 | - | | - |
| Restricted due to subsidiaries and associates | | | (332) | | | | 332 | - | | - |
| Equity as at 30.6.2018 | 10,000 | 55,000 | 3,362 | 466 | (730) | 2,500 | 99,159 | 169,757 | 2,425 | 172,182 |

Dividends:

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 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Consolidated Interim Statement of Cash Flows

| | Notes | 2018 1.1-30.6 | 2017 1.1-30.6 |
|---|-------|------------------|------------------|
| Cash flows from operating activities: | | | |
| Profit for the period | | 7,130 | 8,041 |
| Non-cash items included in profit for the period | | 5,513 | 4,966 |
| Changes in operating assets and liabilities | | (71,398) | (38,088) |
| Dividends received | | 61 | 35 |
| Income tax and bank tax paid | | (2,063) | (674) |
| Net cash used in operating activities | | (60,757) | (25,720) |
| Net cash provided by (used in) investing activities | | | |
| Net investment in subsidiaries and associated companies | | 2,039 | (12) |
| Proceeds from sale of property and equipment | | 6 | 4 |
| Purchase of property and equipment | | (86) | (784) |
| Purchase of intangible assets | | (515) | (1,064) |
| Net cash provided by (used in) investing activities | | 1,444 | (1,856) |
| Net cash provided by financing activities | | | |
| Proceeds from borrowings | | 76,092 | 25,592 |
| Repayment of borrowings | | (9,940) | (9,519) |
| Dividends paid | | (13,000) | (2,449) |
| Dividends paid non-controlling interests | | - | (1,746) |
| Net cash provided by financing activities | | 53,152 | 11,878 |
| Net decrease in cash and cash equivalents | | (6,161) | (15,698) |
| Effects of foreign exchange rate changes | | (107) | (118) |
| Cash and cash equivalents at the beginning of the period | | 187,438 | 240,263 |
| Cash and cash equivalents at the end of the period | | 181,170 | 224,447 |
| Reconciliation of cash and cash equivalents: | | | |
| Cash on hand | 21 | 2,102 | 3,434 |
| Cash balances with Central Bank | 21 | 164,092 | 223,755 |
| Bank accounts | 23 | 30,189 | 14,509 |
| Mandatory reserve and special restricted balances with Central Bank | 21 | (15,213) | (17,251) |
| Cash and cash equivalents at the end of the period | | 181,170 | 224,447 |

The Group has prepared its consolidated interim statement of cash flows using the indirect method. The statement is based on the net profit after tax for the period and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the period.

Interest received from 1 January to 30 June 2018 amounted to ISK 28,539 million (2017: ISK 32,365 million) and interest paid in the same period 2018 amounted to ISK 9,560 million (2017: ISK 11,879 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 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Consolidated Interim Statement of Cash Flows

| | 2018 | 2017 |
|---|------------------|------------------|
| | 1.1-30.6 | 1.1-30.6 |
| Non-cash items included in profit for the period: | | |
| Depreciation and impairment | 320 | 330 |
| Amortisation of intangible assets | 121 | 92 |
| Share of loss (gain) of associates | 34 | (102) |
| Accrued interest and fair value changes on debt issued | 5,047 | 3,245 |
| Net impairment on financial assets | (1,999) | 440 |
| Foreign exchange loss (gain) | 67 | (370) |
| Net gain on sale of subsidiary, property and equipment | (1,555) | (2) |
| Unrealised fair value loss (gain) recognised in profit or loss | 188 | (3) |
| Net profit on non-current assets classified as held for sale | (794) | (2,399) |
| Bank tax | 1,597 | 2,263 |
| Income tax | 2,480 | 1,472 |
| Other changes | 7 | - |
| Non-cash items included in profit for the period | 5,513 | 4,966 |
| Changes in operating assets and liabilities: | | |
| Mandatory reserve and special restricted balances with Central Bank | 2,353 | 29,942 |
| Loans and receivables to credit institutions | (18,436) | (4,838) |
| Loans and receivables to customers | (47,636) | (37,880) |
| Trading assets | (24,439) | (10,611) |
| Other operating assets | 3,045 | (3,262) |
| Non-current assets and liabilities held for sale | 2,165 | 2,090 |
| Deposits with credit institutions and Central Bank | 4,243 | 4,555 |
| Deposits from customers | 11,136 | (19,190) |
| Trading financial liabilities | (270) | 788 |
| Derivatives | (923) | (231) |
| Other operating liabilities | (2,636) | 549 |
| Changes in operating assets and liabilities | (71,398) | (38,088) |

Non-cash transactions 2018

The Group sold a subsidiary during the period and the outstanding balance at the end of the period amounts to ISK 1,241 million.

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 12 to 58 are an integral part of these Condensed Consolidated Interim Financial Statements.

Notes to the Condensed Consolidated Interim Financial Statements

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| 25 | 33 | 55 | 57 |
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| | | 57 | 57 |

Notes to the Condensed Consolidated Interim 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 condensed consolidated interim financial statements for the first half of 2018 ("the interim financial statements") comprise the financial statements of Íslandsbanki hf. ("the Bank" or "Íslandsbanki") and its subsidiaries together referred to as "the Group".

The interim financial statements were authorised for issue by the Board of Directors of Íslandsbanki hf. on 2 August 2018.

2. Basis of preparation

The interim financial statements have been prepared in accordance with the International Accounting Standard (IAS) 34 Interim Financial Reporting, 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 interim financial statements do not include all the information required for annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Group for the year ended 31 December 2017, as well as the unaudited Pillar 3 Report for the year ended 31 December 2017. Both are available on the Bank's website: www.islandsbanki.is.

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, the interim financial statements have been prepared on a going concern basis.

The interim financial statements have been prepared on an historical cost basis except for the following items in the statement of financial position: bonds and debt instruments which are measured at fair value, shares and equity instruments which are measured at fair value, derivative financial instruments which are measured at fair value, non-current assets and disposal groups classified as held for sale which are measured at the lower of its carrying amount and fair value less costs to sell and certain debt securities which are measured at fair value. 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.

The interim 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.

Important accounting estimates and judgements

The preparation of the interim financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities at the date of the interim financial statements, and income and expenses recognised during the reporting period.

Estimates made by management are based on historical experience and other assumptions that are believed to be reasonable.

Key areas where management has made difficult, complex or subjective judgements, include those relating to the allowance for credit losses (see Note 3), the fair value of financial instruments, including derivatives and derecognition of financial assets and liabilities. While management makes its best estimates and assumptions, actual results could differ from these estimates and assumptions.

3. Changes to accounting policies

The accounting policies in the interim financial statements are consistent with those applied in the Group's audited consolidated financial statements for the year ended 31 December 2017, except for changes to the accounting for financial instruments resulting from the adoption of IFRS 9, and the accounting for revenue from contracts with customers resulting from the adoption of IFRS 15. 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 in the areas outlined below, and these new policies were applicable from 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. 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. New or amended interim disclosures have been provided for the current period, where applicable, and comparative period disclosures are consistent with those made in the prior year.

Notes to the Condensed Consolidated Interim Financial Statements

3. Cont'd

Classification and measurement

Financial assets

Financial assets are classified into one of three measurement categories, i.e. measured subsequently at amortised cost, measured subsequently at fair value through other comprehensive income or measured subsequently at fair value through profit or loss. 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.

Reclassification between measurement categories is required 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.

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 (e.g. liquidity risk) and costs (e.g. 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.

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

Notes to the Condensed Consolidated Interim Financial Statements

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

Shares and equity instruments at 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.

Bonds and debt instruments at FVOCI

During the period the Group did not classify any bonds and debt instruments at FVOCI.

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 period 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, with transaction costs recognised immediately in profit or loss. 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)".

Financial liabilities

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" on an accrual basis 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, then the whole fair value change is presented in profit or loss. This is not applicable for the Group during the period.

Hedge accounting

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 76.9 in the Group's audited consolidated financial statements for the year ended 31 December 2017.

Notes to the Condensed Consolidated Interim Financial Statements

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Impairment

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 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.
- 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.

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.

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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 provision for credit losses in the consolidated interim 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.

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.

Notes to the Condensed Consolidated Interim Financial Statements

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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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*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.

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.

| | 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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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. However, the Group changed the presentation in the consolidated income statement of insurance and wholesale annual fees related to credit cards, whereas they 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.

4. Operating segments

The Bank announced changes to its organisational structure in 2017. The purpose of the changes is to adapt the Bank's organisational structure to customers' changed needs and provide them with better banking services. The changes have not been fully implemented. Currently, Retail Banking and Corporate & Investment Banking serve the customers. Wealth Management and Markets no longer operate as separate segments but have been incorporated into the existing segments. At present, Retail Banking is comprised of Personal Banking and Business Banking, however once the organisational changes have been fully implemented the two new segments will replace Retail Banking. The Bank will then have three income-generating units: Personal Banking, Business Banking and Corporate & Investment Banking.

Comparative amounts have not been adjusted.

The Group is currently organised into four main operating segments:

Retail Banking

Personal Banking provides comprehensive financial services to individuals, such as lending, savings and payments; and Business Banking provides wide-ranging financial services to small- and medium-sized enterprises. Comprehensive consultancy services are conducted by experienced advisors located throughout the branches. Business Banking operates Ergo, the asset based financing unit of the Bank. Personal Banking operates Kreditkort, a specialised brand in the credit card sector and Kass, a mobile payments platform.

Corporate & Investment Banking

Corporate & Investment Banking provides universal banking services to large companies, municipalities, institutional investors and affluent individuals. The experienced team members provide 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

Treasury is responsible for funding the Bank's operations and for managing the internal pricing framework. Treasury is also responsible for the Bank's balance sheet management and for the relations with investors, financial institutions, stock exchanges and rating agencies.

Proprietary Trading and Subsidiaries

Proprietary Trading and Subsidiaries include equity and debt investments in the trading book and banking book as well as the impact of subsidiaries and associates. For further information regarding subsidiaries and associates see Note 26 and Note 27.

Cost centres comprise Head Office (Human Resources, Communications, Strategy & Marketing and Legal), Finance, Operations & IT, Risk Management, Group Internal Audit, and Compliance.

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

Following is an overview showing the Group's performance with a breakdown by operating segments.

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| 1 January to 30 June 2018 Operations | Corporate & Retail Investment Banking Banking | | Treasury | Proprietary Trading & Subsidiaries | Cost centres & Eliminations | Total |
|--|---|----------|----------|--|-----------------------------------|-----------|
| | | | | | | |
| Net interest income | 9,950 | 3,040 | 1,983 | 500 | (131) | 15,342 |
| Net fee and commission income | 2,921 | 1,559 | (102) | 1,424 | 8 | 5,810 |
| Other operating income | 8 | 196 | 137 | 2,722 | (1,435) | 1,628 |
| Total operating income | 12,879 | 4,795 | 2,018 | 4,646 | (1,558) | 22,780 |
| Salaries and related expenses | (2,404) | (816) | (84) | (1,444) | (3,204) | (7,952) |
| Other operating expenses | (1,742) | (315) | (216) | (1,121) | (2,376) | (5,770) |
| Deposit Guarantee Fund and bank tax . | (564) | (7) | (1,605) | - | - | (2,176) |
| Net impairment on financial assets | 1,793 | 313 | (93) | (78) | (1) | 1,934 |
| Profit (loss) before cost allocation & tax | 9,962 | 3,970 | 20 | 2,003 | (7,139) | 8,816 |
| Net segment revenue from external customers | 13,223 | 8,785 | (2,665) | 4,865 | (1,428) | 22,780 |
| Of which fee and commission income .. | 3,702 | 1,670 | (74) | 5,379 | (1,441) | 9,236 |
| Net segment revenue from other segments | (344) | (3,990) | 4,683 | (219) | (130) | - |
| At 30 June 2018 | | | | | | |
| Loans to customers | 504,404 | 289,693 | 52 | 5,789 | - | 799,938 |
| Other assets | 3,483 | 906 | 257,301 | 55,418 | (5,304) | 311,804 |
| Total segment assets | 507,887 | 290,599 | 257,353 | 61,207 | (5,304) | 1,111,742 |
| Deposits from customers | 501,110 | 15,172 | 65,353 | 83 | (3,304) | 578,414 |
| Other liabilities | 3,021 | 4,459 | 325,583 | 26,426 | 1,657 | 361,146 |
| Total segment liabilities | 504,131 | 19,631 | 390,936 | 26,509 | (1,647) | 939,560 |
| Allocated equity | 59,595 | 48,050 | 51,203 | 22,250 | (8,916) | 172,182 |
| Risk exposure amount | 417,172 | 327,684 | 26,517 | 49,893 | (1,917) | 819,349 |

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.

| 1 January to 30 June 2017 Operations | Retail | Corporate | Markets | Wealth | Subsidiaries & Equity Treasury Investments | Cost Centres & Eliminations | Total | |
|--|----------|-----------|---------|-----------------|--|-----------------------------------|-----------|-----------|
| | Banking | Banking | | Manage- ment | | | | |
| Net interest income | 8,866 | 3,633 | 893 | 240 | 1,256 | 447 | (124) | 15,211 |
| Net fee and commission income | 2,525 | 289 | 859 | 1,102 | (78) | 2,107 | 9 | 6,813 |
| Other operating income | 8 | 5 | (13) | 53 | 250 | 3,429 | (3,038) | 694 |
| Total operating income | 11,399 | 3,927 | 1,739 | 1,395 | 1,428 | 5,983 | (3,153) | 22,718 |
| Salaries and related expenses | (2,028) | (549) | (633) | (587) | (77) | (1,117) | (2,777) | (7,768) |
| Other operating expenses | (1,716) | (142) | (111) | (127) | (120) | (1,106) | (2,176) | (5,498) |
| Deposit Guarantee Fund and bank tax . | (480) | (1) | - | (30) | (1,476) | - | - | (1,987) |
| Net loan impairment | (94) | 550 | - | - | (4) | 9 | (21) | 440 |
| Profit (loss) before cost allocation & tax | 7,081 | 3,785 | 995 | 651 | (249) | 3,769 | (8,127) | 7,905 |
| Net segment revenue from external customers | 10,031 | 8,737 | 2,033 | 537 | (1,857) | 6,259 | (3,022) | 22,718 |
| Net segment revenue from other segments | 1,368 | (4,810) | (294) | 858 | 3,285 | (276) | (131) | - |
| At 30 June 2017 | | | | | | | | |
| Loans to customers | 407,744 | 308,156 | 312 | - | - | 5,702 | (94) | 721,820 |
| Other assets | 5,241 | 132 | 23,998 | 4,312 | 244,783 | 60,102 | (13,167) | 325,401 |
| Total segment assets | 412,985 | 308,288 | 24,310 | 4,312 | 244,783 | 65,804 | (13,261) | 1,047,221 |
| Deposits from customers | 459,570 | 1,766 | 15 | 31,246 | 84,116 | 6 | (4,312) | 572,407 |
| Other liabilities | 5,873 | 1,619 | 5,371 | 4,206 | 252,267 | 32,052 | (2,502) | 298,886 |
| Total segment liabilities | 465,443 | 3,385 | 5,386 | 35,452 | 336,383 | 32,058 | (6,814) | 871,293 |
| Allocated equity | 47,631 | 48,832 | 1,581 | 2,888 | 63,855 | 21,631 | (10,490) | 175,928 |
| Risk exposure amount | 326,097 | 329,453 | 13,286 | 7,187 | 13,402 | 42,350 | 4,535 | 736,310 |

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5. Classification of financial assets and financial liabilities

| At 30 June 2018 | | | | | | | |
|--|-------|-------------------------|---------------------|---------------------------|---------------------------|-------------------|-----------------------------|
| | Notes | Mandatorily at FVTPL | Held for hedging | Designated as at FVTPL | Fair value through OCI | Amortised cost | Total carrying amount |
| Cash and balances with Central Bank | 21 | - | - | - | - | 166,194 | 166,194 |
| Listed bonds and debt instruments | | 46,702 | - | - | - | - | 46,702 |
| Unlisted bonds and debt instruments | | 1,901 | - | - | - | - | 1,901 |
| Listed shares and equity instruments | | 9,554 | - | - | - | - | 9,554 |
| Unlisted shares and equity instruments | | 2,432 | - | - | 1,595 | - | 4,027 |
| Derivatives | 22 | 2,586 | 623 | - | - | - | 3,209 |
| Loans to credit institutions | 23 | - | - | - | - | 59,858 | 59,858 |
| Loans to customers | 24 | - | - | - | - | 799,938 | 799,938 |
| Other financial assets | | - | - | - | - | 8,018 | 8,018 |
| Total financial assets | | 63,175 | 623 | - | 1,595 | 1,034,008 | 1,099,401 |

| | | | | | | | |
|--|----|--------------|---------------|---------------|----------|----------------|----------------|
| Deposits from CB and credit institutions | 30 | - | - | - | - | 15,391 | 15,391 |
| Deposits from customers | 31 | - | - | - | - | 578,414 | 578,414 |
| Derivative instruments and short positions | 22 | 7,075 | - | - | - | - | 7,075 |
| Debt issued and other borrowed funds | 33 | - | 37,462 | 83,700 | - | 167,198 | 288,360 |
| Subordinated loans | 34 | - | - | - | - | 8,872 | 8,872 |
| Other financial liabilities | | - | - | - | - | 31,375 | 31,375 |
| Total financial liabilities | | 7,075 | 37,462 | 83,700 | - | 801,250 | 929,487 |

| At 31 December 2017 | | | | | | | | |
|--|---------------|---------------------|---------------------|---------------------------|------------------------|-----------------------|-------------------------------------|-----------------------------|
| | | Held for trading | Held for hedging | Designated as at FVTPL | Loans & receivables | Available for sale | Liabilities at amortised cost | Total 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 |

Notes to the Condensed Consolidated Interim Financial Statements

6. 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 30 June 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: Inputs other than the quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

Level 3: Inputs that are unobservable, e.g. internal assumptions.

At 30 June 2018

| | Level 1 | Level 2 | Level 3 | Total |
|---|---------------|--------------|--------------|---------------|
| Bonds and debt instruments | 46,745 | 65 | 1,793 | 48,603 |
| Shares and equity instruments | 9,508 | 96 | 3,977 | 13,581 |
| Derivative instruments | - | 3,209 | - | 3,209 |
| Total financial assets | 56,253 | 3,370 | 5,770 | 65,393 |
| Derivative instruments | - | 7,075 | - | 7,075 |
| Debt issued and other borrowed funds designated as at FVTPL | 83,700 | - | - | 83,700 |
| Total financial liabilities | 83,700 | 7,075 | - | 90,775 |

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 |

Reconciliation of financial instruments categorised into Level 3:

| | Bonds and debt instruments | Shares and equity instruments |
|--|----------------------------|-------------------------------|
| Fair value at 1 January 2018 | 1,828 | 3,373 |
| Purchases | - | 330 |
| Net loss on financial instruments recognised in profit or loss | (64) | (85) |
| Net gain on financial instruments recognised in other comprehensive income | - | 360 |
| Other | 29 | (1) |
| Fair value at 30 June 2018 | 1,793 | 3,977 |

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6. Cont'd

| | 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 the 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.

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

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 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 30 June 2018 the Group's Level 3 equities amounted to ISK 3,977 million. These include shares in five professional investment funds and investment companies investing in unlisted equities and specialised investments in Iceland totalling ISK 1,669 million; and Series C preferred shares in Visa Inc., amounting to ISK 1,595 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 Group's Level 3 bonds amounted to ISK 1,793 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.

7. 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.

After the adoption of IFRS 9, the credit deterioration for "Loans to customers" is reflected in the net carrying amount. Therefore, credit deterioration does not create a difference between the fair value and the net carrying amount.

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.

Notes to the Condensed Consolidated Interim Financial Statements

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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 Bank's current funding premium on similar debt. These liabilities are classified as Level 2. The funding premium is based on the interest margin on the Bank'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 as in Note 6.

At 30 June 2018

| | Level 1 | Level 2 | Level 3 | Total fair value | Carrying amount |
|---|---------|---------|---------|------------------|-----------------|
| Cash and balances with Central Bank | - | 166,194 | - | 166,194 | 166,194 |
| Loans to credit institutions | - | 59,858 | - | 59,858 | 59,858 |
| Loans to customers | - | - | 802,078 | 802,078 | 799,938 |
| Other financial assets | - | 8,018 | - | 8,018 | 8,018 |
| Total financial assets | - | 234,070 | 802,078 | 1,036,148 | 1,034,008 |

| | | | | | |
|--|---------|---------|---|---------|---------|
| Deposits from Central Bank and credit institutions | - | 15,397 | - | 15,397 | 15,391 |
| Deposits from customers | - | 578,589 | - | 578,589 | 578,414 |
| Debt issued and other borrowed funds | 136,614 | 70,373 | - | 206,987 | 204,660 |
| Subordinated loans | 8,827 | - | - | 8,827 | 8,872 |
| Other financial liabilities | - | 31,375 | - | 31,375 | 31,375 |
| Total financial liabilities | 145,441 | 695,734 | - | 841,175 | 838,712 |

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 |

Notes to the Condensed Consolidated Interim Financial Statements

8. 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 | | | | | Assets outside the scope of offsetting disclosure requirements | Total financial assets recognised in the balance sheet |
|-------------------------------|--|------------------------------------|---|-----------------------|--------------------------|---|--|--|--|
| | 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 | | |
| At 30 June 2018 | | | | | | | | | |
| Derivatives | 3,209 | - | 3,209 | (1,053) | (1,344) | (122) | 690 | - | 3,209 |
| Total assets | 3,209 | - | 3,209 | (1,053) | (1,344) | (122) | 690 | - | 3,209 |
| 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 | | | | | Liabilities outside the scope of offsetting disclosure requirements | Total financial liabilities recognised in the balance sheet |
|--|---|-------------------------------|---|------------------|-------------------------|--|--|---|---|
| | 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 | | |
| At 30 June 2018 | | | | | | | | | |
| Derivative instruments and short positions | 7,075 | - | 7,075 | (1,053) | (826) | - | 5,196 | - | 7,075 |
| At 31 December 2017 | | | | | | | | | |
| Derivative instruments and short positions | 5,492 | - | 5,492 | (733) | (492) | - | 4,267 | - | 5,492 |

9. Quarterly statements (unaudited)

| | 2018 Q2 | 2018 Q1 | 2017 Q4 | 2017 Q3 | 2017 Q2 |
|---|--------------|--------------|--------------|--------------|--------------|
| Net interest income | 7,602 | 7,740 | 7,338 | 7,450 | 7,814 |
| Net fee and commission income | 3,032 | 2,778 | 3,632 | 3,305 | 3,543 |
| Net financial income (expense) | 378 | (283) | 260 | (1,084) | 97 |
| Net foreign exchange (loss) gain | (57) | (10) | 81 | 76 | 169 |
| Other operating income | 1,587 | 13 | 122 | 291 | 55 |
| Salaries and related expenses | (4,026) | (3,926) | (4,297) | (3,168) | (4,109) |
| Other operating expenses | (2,846) | (2,924) | (3,358) | (2,879) | (2,739) |
| Contribution to the Depositors' and Investors' Guarantee Fund | (287) | (292) | (288) | (280) | (262) |
| Bank tax | (812) | (785) | (614) | (806) | (752) |
| Net impairment on financial assets | 1,846 | 88 | 969 | 147 | 200 |
| Profit before tax | 6,417 | 2,399 | 3,845 | 3,052 | 4,016 |
| Income tax expense | (1,465) | (1,015) | (816) | (1,072) | (1,133) |
| Profit for the period from continuing operations | 4,952 | 1,384 | 3,029 | 1,980 | 2,883 |
| Profit from discontinued operations, net of income tax | 81 | 713 | 83 | 93 | 2,114 |
| Profit for the period | 5,033 | 2,097 | 3,112 | 2,073 | 4,997 |

Notes to the Condensed Consolidated Interim Financial Statements

10. Net interest income

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|---|------------------|------------------|------------------|------------------|
| Cash and balances with Central Bank* | 4,047 | 5,713 | 1,886 | 2,724 |
| Loans at amortised cost* | 24,376 | 22,997 | 12,023 | 12,183 |
| Financial assets mandatorily at fair value through profit or loss | 827 | - | 396 | - |
| Financial assets designated as at fair value through profit or loss | - | 33 | - | 13 |
| Financial assets held for trading | - | (194) | - | (186) |
| Other assets | 87 | 70 | 37 | 33 |
| Total interest income | 29,337 | 28,619 | 14,342 | 14,767 |
| Deposits from credit institutions and Central Bank* | (206) | (81) | (109) | (64) |
| Deposits from customers* | (7,958) | (9,505) | (3,863) | (4,797) |
| Debt issued and other borrowed funds at fair value through profit or loss | (580) | - | (292) | - |
| Debt issued and other borrowed funds at amortised cost* | (3,958) | (3,809) | (1,908) | (2,084) |
| Subordinated loans* | (71) | - | (37) | - |
| Other financial liabilities | (1,204) | - | (517) | - |
| Other interest expense | (18) | (13) | (14) | (8) |
| Total interest expense | (13,995) | (13,408) | (6,740) | (6,953) |
| Net interest income | 15,342 | 15,211 | 7,602 | 7,814 |

*Interest calculated using the effective interest rate method.

11. Net fee and commission income

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|--|------------------|------------------|------------------|------------------|
| Asset management | 1,031 | 1,002 | 556 | 529 |
| Investment banking and brokerage | 1,048 | 1,077 | 552 | 646 |
| Payment processing | 5,636 | 6,758 | 3,082 | 3,342 |
| Loans and guarantees | 769 | 729 | 429 | 377 |
| Other fee and commission income | 752 | 960 | 344 | 503 |
| Total fee and commission income | 9,236 | 10,526 | 4,963 | 5,397 |
| Brokerage | (130) | (64) | (62) | (31) |
| Clearing and settlement | (3,289) | (3,639) | (1,865) | (1,815) |
| Other commission expenses | (7) | (10) | (4) | (8) |
| Total commission expenses | (3,426) | (3,713) | (1,931) | (1,854) |
| Net fee and commission income | 5,810 | 6,813 | 3,032 | 3,543 |

Notes to the Condensed Consolidated Interim Financial Statements

12. Net financial income

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|---|------------------|------------------|------------------|------------------|
| Net loss on financial assets and liabilities held for trading | - | (87) | - | (115) |
| Net gain on financial assets designated as at fair value through profit or loss | - | 152 | - | 231 |
| Net gain on financial assets and liabilities mandatorily at FVTPL | 276 | - | 459 | - |
| Net loss on financial liabilities designated as at FVTPL | (162) | - | (94) | - |
| Net (loss) gain on fair value hedges | (19) | 44 | 13 | (19) |
| Net financial income | 95 | 109 | 378 | 97 |

13. Net foreign exchange (loss) gain

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|---|------------------|------------------|------------------|------------------|
| Cash and balances with Central Bank | (107) | (127) | (47) | (106) |
| Financial assets held for trading | - | 224 | - | (308) |
| Financial assets designated as at fair value through profit or loss | - | (115) | - | (125) |
| Financial assets mandatorily at fair value through profit or loss | (2,111) | - | (569) | - |
| Loans at amortised cost | 40 | (4,467) | 6,760 | (6,600) |
| Other assets | 23 | (108) | 101 | (211) |
| Net foreign exchange (loss) gain for assets | (2,155) | (4,593) | 6,245 | (7,350) |
| Deposits | (208) | 2,705 | (3,294) | 3,415 |
| Debt issued and other borrowed funds designated as at FVTPL | 849 | - | (1,555) | - |
| Debt issued and other borrowed funds at amortised cost | 885 | 2,077 | (1,232) | 3,790 |
| Subordinated loans | 637 | - | (32) | - |
| Other liabilities | (75) | 181 | (189) | 314 |
| Net foreign exchange gain (loss) for liabilities | 2,088 | 4,963 | (6,302) | 7,519 |
| Net foreign exchange (loss) gain | (67) | 370 | (57) | 169 |

14. Other operating income

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|---|------------------|------------------|------------------|------------------|
| Share of (loss) profit of associates, net of income tax | (34) | 102 | (2) | - |
| Net profit from sale of subsidiaries* | 1,529 | - | 1,529 | - |
| Legal cost and fees | 44 | 57 | 25 | 28 |
| Rental income | 19 | 20 | 10 | 10 |
| Other net operating income | 42 | 36 | 25 | 17 |
| Other operating income | 1,600 | 215 | 1,587 | 55 |

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

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15. Salaries and related expenses

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|--|------------------|------------------|------------------|------------------|
| Salaries | 6,121 | 6,331 | 3,101 | 3,351 |
| Contributions to pension funds | 905 | 892 | 465 | 487 |
| Social security charges and financial activities tax* | 871 | 911 | 438 | 456 |
| Other | 59 | 65 | 26 | 37 |
| Capitalisation of internal staff costs in software development | (4) | (431) | (4) | (222) |
| Salaries and related expenses | 7,952 | 7,768 | 4,026 | 4,109 |

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

16. Other operating expenses

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|-------------------------------------|------------------|------------------|------------------|------------------|
| Professional services | 2,574 | 2,354 | 1,250 | 1,200 |
| Real estate and fixtures | 1,709 | 1,441 | 837 | 717 |
| Depreciation and amortisation | 441 | 422 | 227 | 201 |
| Other administrative expenses | 1,046 | 1,281 | 532 | 621 |
| Other operating expenses | 5,770 | 5,498 | 2,846 | 2,739 |

17. Net impairment on financial assets

| | 2018 1.1-30.6 | 2017 1.1-30.6 | 2018 1.4-30.6 | 2017 1.4-30.6 |
|--|------------------|------------------|------------------|------------------|
| Allowance for expected credit losses, on-balance sheet items | 883 | - | 830 | - |
| Allowance for expected credit losses, off-balance sheet items | 40 | - | 5 | - |
| Specific impairment | - | 569 | - | 248 |
| Collective impairment | - | 162 | - | 86 |
| Impairment changes due to court rulings* | 1,011 | (396) | 1,011 | (178) |
| Impairment reversal due to revised estimated future cash flows | - | 105 | - | 44 |
| Net impairment on financial assets | 1,934 | 440 | 1,846 | 200 |

*For further information see Note 39.

18. 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 first half 2018 is 28.1% (2017: 28.6%).

Income tax recognised in the income statement is specified as follows:

| | 2018 1.1-30.6 | 2017 1.1-30.6 |
|---|------------------|------------------|
| Current tax expense excluding discontinued operations | 2,318 | 1,636 |
| Special financial activities tax | 625 | 402 |
| Difference in prior year's imposed and calculated income tax | (6) | (21) |
| Changes in temporary differences due to deferred tax assets/liabilities | (457) | 246 |
| Total | 2,480 | 2,263 |

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The effective income tax rate is specified as follows:

| | 2018 | | 2017 | |
|--|--------------|--------------|--------------|--------------|
| | 1.1-30.6 | | 1.1-30.6 | |
| Profit before tax | 8,816 | | 7,905 | |
| 20% income tax calculated on the profit for the period | 1,763 | 20.0% | 1,581 | 20.0% |
| Special financial activities tax | 625 | 7.1% | 402 | 5.1% |
| Income not subject to tax | (233) | (2.7%) | (12) | (0.2%) |
| Non-deductible expenses | 320 | 3.6% | 299 | 3.8% |
| Other differences | 5 | 0.1% | (7) | (0.1%) |
| Income tax expense | 2,480 | 28.1% | 2,263 | 28.6% |

The Bank is taxed jointly with its subsidiary Íslandssjóðir hf.

19. Profit from discontinued operations

| | 2018 | | 2017 | |
|---|------------|--------------|-----------|--------------|
| | 1.1-30.6 | | 1.4-30.6 | |
| Net profit (loss) from sale of foreclosed mortgages | 39 | 189 | (1) | 65 |
| Net share of profit from disposal groups held for sale | 755 | 312 | 82 | 313 |
| Net profit from sale of subsidiaries and associates | - | 1,898 | - | 1,736 |
| Profit from discontinued operations, net of income tax | 794 | 2,399 | 81 | 2,114 |

20. Earnings per share

| | Discontinued operations | | | |
|---|-------------------------|-------------|-------------|-------------|
| | Excluded | | Included | |
| | 2018 | 2017 | 2018 | 2017 |
| | 1.1-30.6 | | 1.1-30.6 | |
| Profit attributable to equity holders of the Bank | 6,527 | 5,985 | 7,321 | 8,384 |
| Weighted average number of outstanding shares for the period, million | 10,000 | 10,000 | 10,000 | 10,000 |
| Basic earnings per share | 0.65 | 0.60 | 0.73 | 0.84 |

There were no instruments at the end of the period that could potentially dilute basic earnings per share (2017: none).

21. Cash and balances with Central Bank

| | 30.6.2018 | 31.12.2017 |
|--|----------------|----------------|
| Cash on hand | 2,102 | 1,976 |
| Balances with Central Bank | 148,879 | 169,503 |
| Balances with Central Bank assets subject to special restrictions* | 2,837 | 4,593 |
| Included in cash and cash equivalents | 153,818 | 176,072 |
| Mandatory reserve deposits with Central Bank** | 12,376 | 12,973 |
| Cash and balances with Central Bank | 166,194 | 189,045 |

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*Offshore króna assets, as defined in Act no. 37/2016 and rules no. 490/2016.

**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.

22. Derivative instruments and short positions

| At 30 June 2018 | Assets | Notional values related to assets | Liabilities | Notional values related to liabilities |
|--|--------------|-----------------------------------|--------------|--|
| Interest rate swaps | 1,295 | 111,814 | 2,551 | 131,187 |
| Cross-currency interest rate swaps | 422 | 16,478 | 3,053 | 60,170 |
| Equity forwards | 404 | 3,160 | 122 | 1,520 |
| Equity options | 18 | 211 | - | - |
| Foreign exchange forwards | 78 | 5,680 | 411 | 12,530 |
| Foreign exchange swaps | 921 | 21,329 | 910 | 28,790 |
| Bond forwards | 71 | 7,824 | 28 | 5,810 |
| Derivatives | 3,209 | 166,496 | 7,075 | 240,007 |
| Short positions in listed bonds | - | - | - | - |
| Total | 3,209 | 166,496 | 7,075 | 240,007 |
| At 31 December 2017 | | | | |
| 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 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.

Notes to the Condensed Consolidated Interim Financial Statements

22. Cont'd

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 33) 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 the end of June 2018 was positive and amounted to ISK 331 million. Their total notional amount at the end of June 2018 was ISK 37,140 million. At the beginning of 2018 Íslandsbanki 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 the end of 2017.

23. Loans to credit institutions

| | 30.6.2018 | 31.12.2017 |
|-------------------------------------|---------------|---------------|
| Money market loans | 29,669 | 10,658 |
| Bank accounts | 30,189 | 15,959 |
| Loans to credit institutions | 59,858 | 26,617 |

24. Loans to customers

| At 30 June 2018 | Gross carrying amount | | | ECL allowance | | | Net carrying amount |
|--|-----------------------|---------------|---------------|-----------------|-----------------|-----------------|---------------------|
| | Stage 1 | Stage 2 | Stage 3 | Stage 1 | Stage 2 | Stage 3 | |
| Individuals | 294,492 | 5,564 | 9,348 | (1,009) | (193) | (1,826) | 306,376 |
| Commerce and services | 117,926 | 6,923 | 5,102 | (626) | (96) | (3,018) | 126,211 |
| Construction | 26,661 | 2,385 | 436 | (186) | (173) | (44) | 29,079 |
| Energy | 6,227 | 733 | - | (15) | (12) | - | 6,933 |
| Financial services | 177 | - | 5 | - | - | (3) | 179 |
| Industrial and transportation | 61,614 | 10,505 | 4,150 | (270) | (531) | (765) | 74,703 |
| Investment companies | 14,130 | 2,705 | 724 | (166) | (97) | (396) | 16,900 |
| Public sector and non-profit organisations | 14,190 | 12 | 24 | (17) | - | (1) | 14,208 |
| Real estate | 130,356 | 1,613 | 3,221 | (429) | (96) | (509) | 134,156 |
| Seafood | 81,417 | 9,796 | 603 | (111) | (49) | (463) | 91,193 |
| Loans to customers | 747,190 | 40,236 | 23,613 | (2,829) | (1,247) | (7,025) | 799,938 |

| At 31 December 2017 | Gross amount | Specific impairment allowance | Loans less impairment allowance |
|---|--------------|-------------------------------|---------------------------------|
| | | | |
| 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 |

Notes to the Condensed Consolidated Interim Financial Statements

25. 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 | 1,024 | (708) | (316) | - |
| Transfer to Stage 2 | (290) | 1,349 | (1,059) | - |
| Transfer to Stage 3 | (91) | (951) | 1,042 | - |
| Net remeasurement of loss allowance | (1,054) | 272 | (283) | (1,065) |
| New financial assets originated or purchased | 670 | 170 | 100 | 940 |
| Derecognitions and maturities | (131) | (126) | (609) | (866) |
| Write-offs | - | (3) | (1,521) | (1,524) |
| Recoveries of amounts previously written off | - | - | 166 | 166 |
| Changes in models/risk parameters | - | - | - | - |
| Foreign exchange | - | - | 26 | 26 |
| Unwinding of interests | - | - | 328 | 328 |
| At 30 June 2018 | 2,829 | 1,247 | 7,025 | 11,101 |

At the end of the second quarter 2018 the Group's 12-month ECL (Stage 1) for Cash and balances with Central Bank and Loans to credit institutions amounted to ISK 130 million and for Other financial assets amounted to ISK 5 million. Lifetime ECL credit-impaired (Stage 3) for other financial assets amounted to ISK 61 million.

| 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 |

26. Investments in associates

| | 2018 1.1-30.6 | 2017 1.1-31.12 |
|--|------------------|-------------------|
| Investments in associates at the beginning of the year | 704 | 450 |
| Additions during the period | - | 36 |
| Sales of shares in associates | (39) | - |
| Share of results | (34) | 142 |
| Dividends paid | (17) | (25) |
| Impairment | - | (60) |
| Other | - | 161 |
| Investments in associates | 614 | 704 |

Notes to the Condensed Consolidated Interim Financial Statements

27. Investments in subsidiaries

Significant subsidiaries:

| | | 30.6.2018 | 31.12.2017 |
|--|---------|-----------|------------|
| Borgun hf., a payment acquirer and issuing processor, Ármúli 30, 108 Reykjavík | Iceland | 63.5% | 63.5% |
| Íslandssjóðir hf., an investment fund management company, Hagasmári 3, 201 Kópavogur | Iceland | 100% | 100% |
| IS Þróunarsjóðurinn Langbrók, a professional investment fund, 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% |

Other non-significant subsidiaries:

In addition Íslandsbanki has control over 17 other subsidiaries.

28. Other assets

| | 30.6.2018 | 31.12.2017 |
|---|--------------|--------------|
| Receivables | 5,831 | 6,736 |
| Unsettled securities transactions | 1,237 | 2,620 |
| Accruals | 377 | 205 |
| Prepaid expenses | 475 | 215 |
| Deferred tax assets | 374 | 4 |
| Other assets | 218 | 213 |
| Other assets | 8,512 | 9,993 |

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

| | 30.6.2018 | 31.12.2017 |
|---|--------------|--------------|
| Repossessed collateral | 1,219 | 1,224 |
| Assets of disposal groups classified as held for sale | 182 | 1,542 |
| Total | 1,401 | 2,766 |
| Land and property | 1,196 | 1,194 |
| Industrial equipment and vehicles | 23 | 30 |
| Repossessed collateral | 1,219 | 1,224 |

30. Deposits from Central Bank and credit institutions

| | 30.6.2018 | 31.12.2017 |
|---|---------------|---------------|
| Repurchase agreements with Central Bank | 41 | 92 |
| Deposits from credit institutions | 15,350 | 11,097 |
| Deposits from Central Bank and credit institutions | 15,391 | 11,189 |

Notes to the Condensed Consolidated Interim Financial Statements

31. Deposits from customers

| | 30.6.2018 | 31.12.2017 |
|--------------------------------|----------------|----------------|
| Demand deposits* | 500,696 | 479,590 |
| Time deposits | 77,718 | 87,439 |
| Deposits from customers | 578,414 | 567,029 |

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

Deposits from customers specified by owners:

| | 30.6.2018 | | 31.12.2017 | |
|--|----------------|-------------|----------------|-------------|
| | Amount | % of total | Amount | % of total |
| Central government and state-owned enterprises | 7,011 | 1% | 6,071 | 1% |
| Municipalities | 6,986 | 1% | 7,054 | 1% |
| Companies | 290,937 | 51% | 290,405 | 51% |
| Individuals | 273,480 | 47% | 263,499 | 47% |
| Deposits from customers | 578,414 | 100% | 567,029 | 100% |

32. Pledged assets

| | 30.6.2018 | 31.12.2017 |
|---|----------------|----------------|
| Financial assets pledged as collateral against liabilities | 171,092 | 149,663 |
| Financial assets pledged as collateral in foreign banks | 1,397 | 908 |
| Financial assets pledged as collateral in repurchase agreements | - | 618 |
| Pledged assets against liabilities | 172,489 | 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 30.06.2018 to take into consideration assets pledged as collateral to the Central Bank of Iceland to secure settlement in the Icelandic cash clearing systems.

Notes to the Condensed Consolidated Interim Financial Statements

33. Debt issued and other borrowed funds

| | Issued | Maturity | Maturity type | Terms of interest | 30.6.2018 | 31.12.2017 |
|---|-----------|----------|---------------|---------------------------|----------------|----------------|
| Covered bond in ISK | 2014-2017 | 2019 | At maturity | Fixed, 6.93% | 10,085 | 10,120 |
| Covered bond in ISK | 2015-2018 | 2023 | At maturity | Fixed, 6.40% | 7,681 | 7,469 |
| Covered bond in ISK - CPI-linked | 2012-2014 | 2019 | At maturity | Fixed, 2.84% | 8,774 | 8,666 |
| Covered bond in ISK - CPI-linked | 2014-2015 | 2020 | At maturity | Fixed, 3.47% | 4,169 | 4,117 |
| Covered bond in ISK - CPI-linked | 2015-2017 | 2022 | At maturity | Fixed, 2.98% | 17,703 | 17,467 |
| Covered bond in ISK - CPI-linked | 2012-2018 | 2024 | At maturity | Fixed, 3.45% | 30,242 | 21,963 |
| Covered bond in ISK - CPI-linked | 2015-2017 | 2026 | At maturity | Fixed, 3.37% | 24,344 | 24,049 |
| Covered bond in ISK - CPI-linked | 2017-2018 | 2030 | At maturity | Fixed, 3.00% | 22,258 | 15,089 |
| Covered bonds | | | | | 125,256 | 108,940 |
| Senior unsecured bond in EUR* | 2015-2016 | 2018 | At maturity | Fixed, 2.88% | 19,128 | 19,004 |
| Senior unsecured bond in NOK | 2015 | 2018 | At maturity | Floating, NIBOR + 2.60% | 6,563 | 6,391 |
| Senior unsecured bond in SEK | 2015 | 2019 | At maturity | Floating, STIBOR + 3.10% | 7,146 | 7,660 |
| Senior unsecured bond in EUR | 2017 | 2019 | At maturity | Floating, EURIBOR + 0.38% | 371 | 375 |
| Senior unsecured bond in EUR | 2017 | 2019 | At maturity | Floating, EURIBOR + 0.40% | 2,476 | 2,500 |
| Senior unsecured bond in EUR | 2017 | 2019 | At maturity | Floating, EURIBOR + 0.50% | 1,240 | 1,253 |
| Senior unsecured bond in EUR* | 2016 | 2020 | At maturity | Fixed, 1.75% | 64,572 | 63,651 |
| Senior unsecured bond in SEK | 2018 | 2019 | At maturity | Floating, STIBOR + 0.34% | 1,188 | - |
| Senior unsecured bond in SEK | 2018 | 2021 | At maturity | Floating, STIBOR + 0.60% | 1,186 | - |
| Senior unsecured bond in SEK | 2018 | 2021 | At maturity | Floating, STIBOR + 0.74% | 1,190 | - |
| Senior unsecured bond in SEK | 2018 | 2021 | At maturity | Floating, STIBOR + 0.80% | 11,835 | - |
| Senior unsecured bond in EUR** | 2018 | 2024 | At maturity | Fixed, 1.13% | 37,462 | - |
| Bonds issued | | | | | 154,357 | 100,834 |
| Bills issued | | | | | 8,345 | 7,538 |
| Other debt securities | | | | | 402 | 436 |
| Other borrowed funds | | | | | 8,747 | 7,974 |
| Debt issued and other borrowed funds | | | | | 288,360 | 217,748 |

*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 30 June 2018 the total carrying amount of the bond issuance amounted to ISK 83,700 million and included in the amount are fair value changes amounting to ISK 1,314 million. The carrying amount of the debt securities designated as at fair value through profit or loss at 30 June 2018 was ISK 1,612 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 22). 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 30 June 2018 the total carrying amount of the bond issuance amounted to ISK 37,462 million and included in the amount are fair value changes amounting to ISK 275 million.

Íslandsbanki did not repurchase own senior or covered bonds during the period.

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

34. Subordinated loans

| | Issued | Maturity | Maturity type | Terms of interest | 30.6.2018 | 31.12.2017 |
|--|--------|----------|---------------|-------------------------|--------------|--------------|
| Loans which qualify as Tier 2 capital: | | | | | | |
| Subordinated loans in SEK | 2017 | 2027 | At maturity | Floating, STIBOR + 2.0% | 8,872 | 9,505 |
| Subordinated loans | | | | | 8,872 | 9,505 |

Notes to the Condensed Consolidated Interim Financial Statements

35. Changes in liabilities arising from financing activities

| | 31.12.2017 | Reclassi- fication IFRS 9 | 1.1.2018 | Cash flows | Non-cash changes | | | 30.6.2018 |
|---|----------------|---------------------------------|----------------|---------------|---------------------|---------------------------------|-----------------------|----------------|
| | | | | | Accrued interest | Foreign exchange movement | Fair value changes | |
| Coverd bonds NIL | 17,589 | - | 17,589 | (368) | 545 | - | - | 17,766 |
| Coverd bonds CPI | 91,351 | - | 91,351 | 13,386 | 2,753 | - | - | 107,490 |
| Senior unsecured bonds FX | 37,182 | (19,003) | 18,179 | 15,196 | 260 | (440) | - | 33,195 |
| Senior unsecured bonds FX at fair value ... | - | 82,655 | 82,655 | - | 580 | (849) | 1,314 | 83,700 |
| Assets held to hedge long-term borrow. | 63,652 | (63,652) | - | 37,436 | 196 | (445) | 275 | 37,462 |
| Short-term borrowings | 7,974 | - | 7,974 | 569 | 204 | - | - | 8,747 |
| Subordinated loans | 9,505 | - | 9,505 | (67) | 71 | (637) | - | 8,872 |
| Total | 227,253 | - | 227,253 | 66,152 | 4,609 | (2,371) | 1,589 | 297,232 |

| | 1.1.2017 | Cash flows | Accrued interest | Non-cash changes | | | Other | 31.12.2017 |
|---|----------------|---------------|---------------------|---------------------------------|-----------------------|-----------------|----------|----------------|
| | | | | Foreign exchange movement | Fair value changes | | | |
| Coverd bonds NIL | 15,491 | 1,031 | 1,067 | - | - | - | - | 17,589 |
| Coverd 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) | - | - |
| Assets held to hedge long-term borrowings | 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 |

36. Other liabilities

| | 30.6.2018 | 31.12.2017 |
|---|---------------|---------------|
| Accruals | 4,105 | 4,049 |
| Liabilities to retailers for credit cards | 24,224 | 23,878 |
| Provision for effects of court rulings | 349 | 1,811 |
| Off-balance sheet loan commitments and financial guarantees | 634 | 64 |
| Withholding tax | 734 | 1,596 |
| Unsettled securities transactions | 960 | 1,384 |
| Deferred income | 83 | 199 |
| Sundry liabilities | 1,358 | 2,966 |
| Other liabilities | 32,447 | 35,947 |

Notes to the Condensed Consolidated Interim Financial Statements

36. Cont'd

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 | 65 | (42) | (23) | - |
| Transfer to Stage 2 | (12) | 20 | (8) | - |
| Transfer to Stage 3 | (3) | (66) | 69 | - |
| Net remeasurement of loss allowance | (204) | 19 | (90) | (275) |
| New financial assets originated or purchased | 209 | 71 | 110 | 390 |
| Derecognitions and maturities | (116) | (15) | (24) | (155) |
| At 30 June 2018 | 406 | 88 | 140 | 634 |

37. 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, and the members of the Board of Directors of ISFI are defined as related parties of the Group. 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 of the parent company, the key management personnel, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties. The Group's associates, and their key management personnel and legal entities controlled by them, 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 21 and Deposits from the Central Bank are disclosed under Note 30.

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

| At 30 June 2018 | Commitments | | | |
|---|-------------|-----------------|---------------------------|--------------|
| | Assets | Liabilities | Net balance and overdraft | |
| Shareholders with control over the Group | - | (104) | (104) | 1 |
| Board of Directors and key management personnel | 194 | (426) | (232) | 47 |
| Associated companies and other related parties | 279 | (330) | (51) | 227 |
| Balances with related parties | 473 | (860) | (387) | 275 |
| | | Interest income | Interest expense | Other income |
| Shareholders with control over the Group | | - | (1) | - |
| Board of Directors and key management personnel | | 7 | (8) | - |
| Associated companies and other related parties | | 9 | (4) | 1 |
| Transactions with related parties | | 16 | (13) | 1 |

Notes to the Condensed Consolidated Interim Financial Statements

37. Cont'd

At 31 December 2017

| | | | | Commitments |
|---|------------|-----------------|---------------------------|--------------|
| | Assets | Liabilities | Net balance and overdraft | |
| 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 |
| | | Interest income | Interest expense | Other income |
| 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 |
| Transactions with related parties | | 40 | (41) | 2 |

No share option programmes were operated during the reporting period 1 January - 30 June 2018.

38. Custody assets

| | 30.6.2018 | 31.12.2017 |
|---|-----------|------------|
| Custody assets - not managed by the Group | 2,265,711 | 2,101,434 |

39. Contingencies

Provisions

Foreign currency-linked loan contracts

The statute of limitations for claims relating to foreign currency-linked loan contracts passed on 16 June 2018. No new cases were filed in the last remaining weeks before that date. The effect of the two remaining open cases (both filed by individuals) is insignificant. A provision of ISK 1,011 million (see Note 17) due to such loan contracts was derecognised in the period.

Variable rate loan contracts

In September 2014, the Icelandic Consumer Agency published its decision on a matter regarding the terms of, and information relating to the granting of, a consumer mortgage contract with interest reset terms granted by the Group in 2005. The Consumer Agency found that the terms offered by the Group and its predecessors, regarding the method and conditions of resetting interest rates, 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 recognised a provision of ISK 800 million against the loss due to this ruling. On 30 June 2018 the Group had repaid ISK 451 million to affected customers. A provision of ISK 349 million remains (see Note 36) and the Group expects to process the repayments to the remaining customers in the third quarter of 2018.

Notes to the Condensed Consolidated Interim Financial Statements

39. Cont'd

Contingent liabilities

Borgun hf.

Borgun hf. is a payment acquirer and issuing processor and a subsidiary of Íslandsbanki. Landsbankinn hf. sold its 31.2% stake in Borgun in late 2014. Since early 2016 Landsbankinn has been criticised (among others by the Icelandic National Audit Office) for not having foreseen in the process of the sale that Borgun was entitled to proceeds from the Visa Inc. takeover of Visa Europe. Landsbankinn's response to the criticism is that it considers that Borgun's management had not released information on all factors that could affect the value of Borgun during the sales process. In order to reclaim the alleged loss, Landsbankinn filed a lawsuit on 12 January 2017, claiming damages for having been deprived of the true value of the stake involved in the sale.

Landsbankinn hf. (the plaintiff) is asking the court to affirm the joint liability of Borgun hf., BPS ehf., Eignarhaldsfélagið Borgun slf. and the former CEO of Borgun to pay damages for the plaintiff's alleged loss resulting from the defendants' negligence to inform the plaintiff of the value of Borgun's share in Visa Europe Ltd. The defendants have denied liability. The plaintiff does not quantify the claim, however, 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

Kortabjónustan hf.

Kortabjónustan hf., a payment acquirer, filed a suit against Íslandsbanki hf., Arion banki hf., Landsbankinn hf., Borgun hf. and Valitor hf. in June 2013 asking for ISK 923 million in damages, collectively. The courts have dismissed the case repeatedly, the last verdict to that effect was passed last May. 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 from the Byr Winding-up Committee ("Committee") and the Icelandic Ministry of Finance and Economic Affairs ("Ministry"). According to standard practice, the Group retained the right to re-evaluate the fair value of the net assets acquired and to demand a refund if the fair value of the net assets was not in line with what was presented in Byr's financial statements. Based on this, the Group filed a claim amounting to ISK 6,943 million plus interest with the Committee in June 2013. The claim is filed as a priority claim, according to Article 110 of the Act on Bankruptcy no. 21/1991. The Committee rejected the claim with a letter dated 30 September 2013. At a creditors' meeting in December 2013 it was decided that the Committee would refer the dispute to the District Court of Reykjavik. A formal claim amounting to ISK 911 million plus interest was filed with the Ministry on 24 September 2014. Both claims have now been filed with the District Court of Reykjavik. Furthermore, at the request of the Group, the District Court has appointed two independent professionals to perform a formal evaluation of the Group's claim on the Ministry and the Committee. The Group expects the evaluation will be completed in the fourth quarter of 2018. Court proceedings are expected to commence once the evaluation has been completed and filed with the District Court. The Group has not recognised any revenues relating to this claim.

The District Court of Reykjavik confirmed the Composition Agreement of Byr Savings Bank on 8 January 2016. The Agreement includes reservations due to Íslandsbanki's claim and is not expected to impact the proceedings described above.

40. Events after the reporting period

No events have arisen after the reporting period that require amendments or additional disclosures in the interim financial statements for the first half of 2018.

Notes to the Condensed Consolidated Interim Financial Statements

41. Risk management

Risk governance

Íslandsbanki is exposed to various risks and managing these risks is an integral part of the Bank's operations. More information about the Bank's risk management and risk assessment processes is available in the unaudited Pillar 3 Report. The Pillar 3 Report is available on the Bank's website: www.islandsbanki.is.

42. 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.

43. 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, see Note 24. 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:

Notes to the Condensed Consolidated Interim Financial Statements

Credit risk exposure

43. Cont'd

Maximum credit exposure at 30 June 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 | - | 166,194 | - | - | - | - | - | - | - | - | - | 166,194 |
| Bonds and debt instruments | - | 34,350 | - | - | 338 | 11,737 | 1,613 | 64 | 481 | 20 | - | 48,603 |
| Derivatives | 6 | - | 148 | 26 | 1,422 | 3,690 | 220 | 1,529 | - | 356 | 208 | 7,605 |
| Loans to credit institutions | - | - | - | - | - | 59,858 | - | - | - | - | - | 59,858 |
| Loans to customers: | 306,376 | - | 126,211 | 29,079 | 6,933 | 179 | 74,703 | 16,900 | 14,208 | 134,156 | 91,193 | 799,938 |
| Overdrafts | 10,970 | - | 12,918 | 3,943 | 40 | 2 | 5,690 | 1,156 | 2,598 | 4,436 | 7,664 | 49,417 |
| Credit cards | 15,311 | - | 1,493 | 235 | 3 | 17 | 419 | 29 | 110 | 62 | 31 | 17,710 |
| Mortgages | 236,158 | - | - | - | - | - | - | - | - | - | - | 236,158 |
| Capital leases | 7,075 | - | 27,143 | 2,260 | 6 | - | 6,488 | 131 | 53 | 1,138 | 180 | 44,474 |
| Other loans | 36,862 | - | 84,657 | 22,641 | 6,884 | 160 | 62,106 | 15,584 | 11,447 | 128,520 | 83,318 | 452,179 |
| Other financial assets | 377 | 7 | 115 | 1 | 10 | 7,256 | 13 | 38 | 103 | 42 | 56 | 8,018 |
| Off-balance sheet items: | 35,270 | - | 29,712 | 12,832 | 9,716 | 4,642 | 15,673 | 4,678 | 4,016 | 14,261 | 16,605 | 147,405 |
| Financial guarantees | 1,544 | - | 5,334 | 4,273 | 12 | 1,164 | 2,678 | 87 | 5 | 888 | 6,459 | 22,444 |
| Undrawn loan commitments | - | - | 10,869 | 5,873 | 9,461 | - | 8,779 | 2,309 | - | 10,362 | 4,336 | 51,989 |
| Undrawn overdrafts | 10,190 | - | 9,442 | 1,996 | 211 | 3,348 | 3,188 | 2,142 | 3,322 | 2,794 | 5,653 | 42,286 |
| Credit card commitments | 23,536 | - | 4,067 | 690 | 32 | 130 | 1,028 | 140 | 689 | 217 | 157 | 30,686 |
| Total maximum credit exposure | 342,029 | 200,551 | 156,186 | 41,938 | 18,419 | 87,362 | 92,222 | 23,209 | 18,808 | 148,835 | 108,062 | 1,237,621 |

Notes to the Condensed Consolidated Interim Financial Statements

43. Cont'd

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 |

Notes to the Condensed Consolidated Interim Financial Statements

44. 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, fishing 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 38,368 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 30 June 2018 | Maximum exposure to credit risk | Real estate | Vessels | Cash & securities | Vehicles & equipment | Other collateral | Total credit exposure covered by collateral |
|--|---------------------------------|----------------|---------------|-------------------|----------------------|------------------|---|
| Collateral held against non credit-impaired exposures | | | | | | | |
| Derivatives | 7,605 | - | - | 2,541 | - | - | 2,541 |
| Loans and commitments to customers: | 930,250 | 511,083 | 74,203 | 6,714 | 51,250 | 58,343 | 701,593 |
| Individuals | 333,951 | 253,598 | 5 | 455 | 13,502 | 146 | 267,706 |
| Commerce and services | 153,747 | 57,261 | 718 | 221 | 29,744 | 22,977 | 110,921 |
| Construction | 41,507 | 23,585 | - | 504 | 1,802 | 3,899 | 29,790 |
| Energy | 16,649 | 3,625 | - | 369 | - | 87 | 4,081 |
| Financial services | 4,818 | - | - | 168 | - | - | 168 |
| Industrial and transportation | 86,971 | 26,642 | 10 | 101 | 5,707 | 11,977 | 44,437 |
| Investment companies | 21,248 | 7,271 | 28 | 2,764 | 96 | 6,521 | 16,680 |
| Public sector and non-profit organisations | 18,201 | 996 | - | 10 | 39 | 2 | 1,047 |
| Real estate | 145,505 | 131,125 | - | 832 | 219 | 877 | 133,053 |
| Seafood | 107,653 | 6,980 | 73,442 | 1,290 | 141 | 11,857 | 93,710 |
| Total | 937,855 | 511,083 | 74,203 | 9,255 | 51,250 | 58,343 | 704,134 |
| | | | | | | | |
| | | | | | | | |
| Collateral held against credit-impaired exposures | | | | | | | |
| Derivatives | - | - | - | - | - | - | - |
| Loans and commitments to customers: | 17,093 | 11,319 | 2,368 | 180 | 442 | 320 | 14,629 |
| Individuals | 7,695 | 6,683 | - | 12 | 161 | 4 | 6,860 |
| Commerce and services | 2,176 | 1,687 | 187 | 6 | 78 | 11 | 1,969 |
| Construction | 404 | 343 | - | - | 9 | 24 | 376 |
| Financial services | 3 | - | - | - | - | - | - |
| Industrial and transportation | 3,405 | 403 | 2,177 | 92 | 135 | 281 | 3,088 |
| Investment companies | 330 | 233 | - | 52 | 12 | - | 297 |
| Public sector and non-profit organisations | 23 | 12 | - | - | - | - | 12 |
| Real estate | 2,912 | 1,860 | - | 18 | 3 | - | 1,881 |
| Seafood | 145 | 98 | 4 | - | 44 | - | 146 |
| Total | 17,093 | 11,319 | 2,368 | 180 | 442 | 320 | 14,629 |

Notes to the Condensed Consolidated Interim Financial Statements

44. Cont'd

| 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 |

45. 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 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.

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.

The Group is in the process of implementing a new harmonised definition of default that encompasses four similar definitions previously in use, i.e. default according to Article 178 of the CRR (Capital Requirements Regulation), credit-impaired according to IFRS 9 (Stage 3), non-performing according to FINREP and Risk class 10 according to the Group's internal classification. The new definition is broader than each individual definition, in particular the previous definition of Risk class 10. Currently, ISK 6,871 million of the exposure in Stage 3 is attributable to the new definition and would otherwise not have been classified as Risk class 10.

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At 30 June 2018

| Loans to customers: | Stage 1 | Stage 2 | Stage 3 | Total |
|----------------------------|----------------|---------------|---------------|----------------|
| Risk class 1-4 | 211,074 | 164 | - | 211,238 |
| Risk class 5-6 | 323,866 | 5,029 | - | 328,895 |
| Risk class 7-8 | 171,079 | 25,430 | - | 196,509 |
| Risk class 9 | 35,068 | 9,558 | - | 44,626 |
| Risk class 10 | - | - | 23,522 | 23,522 |
| Unrated | 6,103 | 55 | 91 | 6,249 |
| | 747,190 | 40,236 | 23,613 | 811,039 |
| ECL | (2,829) | (1,247) | (7,025) | (11,101) |
| Net carrying amount | 744,361 | 38,989 | 16,588 | 799,938 |

| Off-balance sheet loan commitments and financial guarantees: | Stage 1 | Stage 2 | Stage 3 | Total |
|--|----------------|--------------|------------|----------------|
| Risk class 1-4 | 76,300 | 32 | - | 76,332 |
| Risk class 5-6 | 48,217 | 857 | - | 49,074 |
| Risk class 7-8 | 18,157 | 1,351 | - | 19,508 |
| Risk class 9 | 1,555 | 437 | - | 1,992 |
| Risk class 10 | - | - | 645 | 645 |
| Unrated | 487 | 1 | - | 488 |
| | 144,716 | 2,678 | 645 | 148,039 |
| ECL | (406) | (88) | (140) | (634) |
| Net carrying amount | 144,310 | 2,590 | 505 | 147,405 |

| At 31 December 2017 | Risk class | Risk class | Risk class | Risk class | Risk class | Unrated | Total |
|--|----------------|----------------|----------------|---------------|--------------|--------------|----------------|
| | 1-4 | 5-6 | 7-8 | 9 | 10 | | |
| 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 |

46. 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 the assets should be classified as Stage 3 credit-impaired.

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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 30 June 2018

| | Gross carrying amount of forborne assets | | | |
|-------------------|--|---------------|--------------|---------------|
| | Stage 1 | Stage 2 | Stage 3 | Total |
| Individuals | 2,185 | 1,858 | 1,412 | 5,455 |
| Companies | 4,404 | 13,624 | 5,655 | 23,683 |
| Total | 6,589 | 15,482 | 7,067 | 29,138 |

| | ECLs of forborne assets | | | |
|-------------------|-------------------------|---------------|-----------------|-----------------|
| | Stage 1 | Stage 2 | Stage 3 | Total |
| Individuals | (11) | (72) | (199) | (282) |
| Companies | (71) | (407) | (1,282) | (1,760) |
| Total | (82) | (479) | (1,481) | (2,042) |

| | Gross carrying amount |
|--|-----------------------|
| Gross carrying amount written off during the reporting period and still subject to enforcement activity: | |
| Individuals | 477 |
| Companies | 250 |
| Total | 727 |

47. 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 three large exposures, an increase of one since the last reporting date. The new exposure is due to a new connection of two clients that previously were not connected. 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.

| Groups of connected clients | 30.6.2018 | |
|-----------------------------|-----------|-------|
| | Before | After |
| Group 1 | 94% | 0% |
| Group 2 | 15% | 13% |
| Group 3 | 12% | 12% |
| Group 4 | 12% | 11% |

| Groups of connected clients | 31.12.2017 | |
|-----------------------------|------------|-------|
| | Before | After |
| Group 1 | 102% | 0% |
| Group 2 | 11% | 11% |
| Group 3 | 10% | 10% |

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48. 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 the end of June 2018 and at year-end 2017.

| Net Stable Funding Ratio | 30.6.2018 | 31.12.2017 |
|---------------------------------|-----------|------------|
| For all currencies | 117% | 117% |
| Foreign currencies | 147% | 122% |

| Liquidity Coverage Ratio | 30.6.2018 | 31.12.2017 |
|---------------------------------|-----------|------------|
| For all currencies | 154% | 142% |
| Foreign currencies | 218% | 155% |

| | For all currencies | | Foreign currencies | |
|--|--------------------|----------|--------------------|-----------|
| | Unweighted | Weighted | Unweighted | Weighted |
| At 30 June 2018 | | | | |
| Liquid assets level 1 | 185,668 | 185,668 | 31,140 | 31,140 |
| Liquid assets level 2 | 2,404 | 696 | 2,404 | 696 |
| Total liquid assets | 188,072 | 186,364 | 33,544 | 31,836 |
| Deposits | 455,505 | 136,457 | 70,040 | 32,626 |
| Debt issued | 21,953 | 21,953 | 19,718 | 19,718 |
| Other outflows | 99,137 | 31,722 | 23,962 | 6,026 |
| Total outflows | 576,595 | 190,132 | 113,720 | 58,370 |
| Short term deposits with other banks | 57,043 | 49,183 | 56,908 | 49,179 |
| Other inflows | 32,608 | 19,757 | 2,682 | 11,260 |
| Restrictions on inflows | - | - | - | (16,661) |
| Total inflows | 89,651 | 68,940 | 59,590 | 43,778 |
| Liquidity coverage ratio | | 154% | | 218% |

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| 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% |

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.

Maturity analysis 30 June 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 | 15,391 | 4,875 | 5,715 | - | 5,241 | - | - | 15,831 |
| Deposits from customers | 578,414 | 405,977 | 96,931 | 40,172 | 25,592 | 30,503 | - | 599,175 |
| Debt issued and other borrowed funds | 288,360 | 402 | 23,655 | 46,285 | 120,670 | 134,225 | - | 325,237 |
| Subordinated loans | 8,872 | - | 37 | 129 | 1,133 | 11,222 | - | 12,521 |
| Other financial liabilities | 31,375 | 27,959 | 2,030 | 1,386 | - | - | - | 31,375 |
| Total | 922,412 | 439,213 | 128,368 | 87,972 | 152,636 | 175,950 | - | 984,139 |

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 | 22,444 | - | - | - | - | - | 22,444 |
| Undrawn loan commitments | 51,989 | - | - | - | - | - | 51,989 |
| Undrawn overdrafts | 42,286 | - | - | - | - | - | 42,286 |
| Credit card commitments | 30,686 | - | - | - | - | - | 30,686 |
| Total | 147,405 | - | - | - | - | - | 147,405 |
| Total non-derivative financial liabilities and off-balance sheet liabilities | 586,618 | 128,368 | 87,972 | 152,636 | 175,950 | - | 1,131,544 |

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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 | - | 31,032 | 50,179 | 60,752 | 1,202 | - | 143,165 |
| Outflow | - | (32,231) | (51,080) | (65,501) | (1,337) | - | (150,149) |
| Total | - | (1,199) | (901) | (4,749) | (135) | - | (6,984) |
| Net settled derivatives | - | (149) | - | - | - | - | (149) |
| Total | - | (1,348) | (901) | (4,749) | (135) | - | (7,133) |

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.

| 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 | 166,194 | 37,022 | 126,335 | - | - | 2,837 | - | 166,194 |
| Bonds and debt instruments | 48,603 | 741 | 18,520 | 11,797 | 6,703 | 10,842 | - | 48,603 |
| Shares and equity instruments | 13,581 | - | - | - | - | - | 13,581 | 13,581 |
| Loans to credit institutions | 59,858 | 28,269 | 31,589 | - | - | - | - | 59,858 |
| Loans to customers | 799,938 | 6,106 | 82,315 | 84,156 | 245,176 | 382,185 | - | 799,938 |
| Other financial assets | 8,018 | 1,993 | 534 | 194 | 47 | 6 | 5,244 | 8,018 |
| Total | 1,096,192 | 74,131 | 259,293 | 96,147 | 251,926 | 395,870 | 18,825 | 1,096,192 |

| 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 | - | 14,549 | 50,876 | 40,737 | 924 | - | 107,086 |
| Outflow | - | (13,522) | (49,434) | (39,607) | (976) | - | (103,539) |
| Total | - | 1,027 | 1,442 | 1,130 | (52) | - | 3,547 |
| Net settled derivatives | - | 467 | - | - | - | - | 467 |
| Total | - | 1,494 | 1,442 | 1,130 | (52) | - | 4,014 |

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 |

Notes to the Condensed Consolidated Interim Financial Statements

48. Cont'd

| 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 |
|--|---------|---------|--------|---------|---------|---|-----------|

| 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 | 30.6.2018 | 31.12.2017 |
|---|----------------|----------------|
| Cash and balances with Central Bank | 150,169 | 183,834 |
| Domestic bonds eligible as collateral against borrowing at Central Bank | 5,748 | 3,654 |
| Foreign government bonds | 30,553 | 11,872 |
| Loans to credit institutions | 57,043 | 23,768 |
| Total | 243,513 | 223,128 |

Notes to the Condensed Consolidated Interim Financial Statements

49. 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.

| At 30 June 2018 | Deposits maturing within 30 days | | | | | |
|---|----------------------------------|------------|---------------|------------|----------------|----------------|
| | Less stable | Weight (%) | Stable | Weight (%) | Term deposits | Total deposits |
| Retail | 125,803 | 10% | 67,054 | 5% | 66,778 | 259,635 |
| SMEs | 62,619 | 10% | 15,122 | 5% | 6,923 | 84,664 |
| Operational relationships | 2,412 | 25% | - | 5% | - | 2,412 |
| Corporations | 61,344 | 40% | 292 | 20% | 22,629 | 84,265 |
| Sovereigns, Central Bank and public sector entities | 7,952 | 40% | 232 | 20% | 854 | 9,038 |
| Financial institutions in composition | 2,122 | 100% | - | - | - | 2,122 |
| Pension funds | 43,093 | 100% | - | - | 27,735 | 70,828 |
| Domestic financial entities | 25,999 | 100% | - | - | 28,838 | 54,837 |
| Foreign financial entities | 1,375 | 100% | - | - | 7,273 | 8,648 |
| Other foreign entities | 12,440 | 100% | 1,973 | 25% | 2,943 | 17,356 |
| Total | 345,159 | | 84,673 | | 163,973 | 593,805 |

At 31 December 2017

| | | | | | | |
|---|----------------|------|---------------|-----|----------------|----------------|
| 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 |

50. 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.

Notes to the Condensed Consolidated Interim Financial Statements

51. 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.

52. 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 5 since netting between short and long positions is not applied here. Derivatives and securities used for hedging are excluded from the table.

| Trading bonds and debt instruments, long positions | 30.6.2018 | | | 31.12.2017 | | |
|--|---------------|-------------|----------------|---------------|-------------|----------------|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | 1,352 | 7.06 | (0.95) | 1,750 | 7.17 | (1.25) |
| Non-indexed | 31,312 | 0.25 | (0.77) | 14,148 | 0.51 | (0.73) |
| Total | 32,664 | 0.53 | (1.72) | 15,898 | 1.24 | (1.98) |

| Trading bonds and debt instruments, short positions | 30.6.2018 | | | 31.12.2017 | | |
|---|------------|-------------|-------------|------------|----------|----------|
| | MV | Duration | BPV | MV | Duration | BPV |
| Indexed | - | - | - | - | - | - |
| Non-indexed | 183 | 8.00 | 0.15 | - | - | - |
| Total | 183 | 8.00 | 0.15 | - | - | - |

| | | | | | | |
|---|---------------|-------------|----------------|---------------|-------------|----------------|
| Net position of trading bonds and debt instruments | 32,481 | 0.49 | (1.57) | 15,898 | 1.24 | (1.98) |
|---|---------------|-------------|----------------|---------------|-------------|----------------|

53. 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 following table displays assets and liabilities in the banking book according to the next interest reset rate date as of 30 June 2018. 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 in the year-end 2017 but has now been 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 3,000 with a carrying amount of ISK 40 billion. The Bank plans to reduce the interest rate risk by offering customers owing the remaining contracts to move back to five year interest reset periods at a more favourable interest rate, and by issuing more longer dated fixed rate debt.

Notes to the Condensed Consolidated Interim Financial Statements

53. Cont'd

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|--|----------------|------------------|------------------|----------------|------------------|------------------|------------------|
| Balances with Central Bank | 163,357 | 2,837 | - | - | - | - | 166,194 |
| Bonds and debt instruments | 1,765 | 65 | 61 | 176 | 107 | 90 | 2,264 |
| Loans to credit institutions | 59,858 | - | - | - | - | - | 59,858 |
| Loans to customers | 533,766 | 33,763 | 34,730 | 149,295 | 3,817 | 44,567 | 799,938 |
| Total | 758,746 | 36,665 | 34,791 | 149,471 | 3,924 | 44,657 | 1,028,254 |
| Off-balance sheet items | 143,737 | 11,789 | 3,909 | 68,667 | - | - | 228,102 |
| Effect of derivatives held for hedging | - | - | - | 37,190 | - | - | 37,190 |
| Liabilities | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
| Deposits from Central Bank and credit institutions | 10,549 | - | 4,842 | - | - | - | 15,391 |
| Deposits from customers | 563,423 | 6,254 | - | 8,696 | 41 | - | 578,414 |
| Debt issued and other borrowed funds | 23,034 | 54,518 | 5,357 | 83,465 | 99,728 | 22,258 | 288,360 |
| Subordinated loans | - | 8,872 | - | - | - | - | 8,872 |
| Total | 597,006 | 69,644 | 10,199 | 92,161 | 99,769 | 22,258 | 891,037 |
| Off-balance sheet items | 144,143 | 4,975 | 46,551 | 33,138 | 766 | - | 229,573 |
| Effect of derivatives held for hedging | 37,164 | - | - | - | - | - | 37,164 |
| Net interest gap on 30 June 2018 | 124,170 | (26,165) | (18,050) | 130,029 | (96,611) | 22,399 | 135,772 |

The following table displays assets and liabilities in the banking book according to the next interest rate reset date as of 31 December 2017. In the table below the total amount for loans to customers is shown before collective impairment allowance is subtracted and is therefore not the same as the total amount shown in the financial statement.

| Assets | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
|--|----------------|----------------|-----------------|----------------|------------------|------------------|----------------|
| Balances with Central Bank | 184,494 | 4,551 | - | - | - | - | 189,045 |
| Bonds and debt instruments | 1,805 | 129 | - | 348 | 19 | 72 | 2,373 |
| Loans to credit institutions | 26,617 | - | - | - | - | - | 26,617 |
| Loans to customers | 515,861 | 28,018 | 37,858 | 165,981 | 3,636 | 5,548 | 756,902 |
| Total | 728,777 | 32,698 | 37,858 | 166,329 | 3,655 | 5,620 | 974,937 |
| Off-balance sheet items | 81,929 | 49,681 | 521 | 5,847 | - | - | 137,978 |
| Effect of derivatives held for hedging | - | - | - | 62,463 | - | - | 62,463 |
| Liabilities | 0-3 months | 3-12 months | 1-2 years | 2-5 years | 5-10 years | Over 10 years | Total |
| Deposits from Central Bank and credit institutions | 9,158 | - | 2,031 | - | - | - | 11,189 |
| Deposits from customers | 548,921 | 8,090 | 789 | 8,488 | 741 | - | 567,029 |
| Debt issued and other borrowed funds | 16,886 | 24,518 | 22,539 | 85,236 | 53,481 | 15,089 | 217,749 |
| Subordinated loans | 9,505 | - | - | - | - | - | 9,505 |
| Total | 584,470 | 32,608 | 25,359 | 93,724 | 54,222 | 15,089 | 805,472 |
| Off-balance sheet items | 64,504 | 2,555 | 14,247 | 56,115 | 744 | - | 138,165 |
| Effect of derivatives held for hedging | 62,537 | - | - | - | - | - | 62,537 |
| Net interest gap on 31 December 2017 | 99,195 | 47,216 | (1,227) | 84,800 | (51,311) | (9,469) | 169,204 |

Notes to the Condensed Consolidated Interim Financial Statements

54. 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 30 June 2018

| Assets | EUR | USD | GBP | CHF | JPY | SEK | NOK | DKK | CAD | Other foreign currencies | Total foreign currencies |
|--|------------------|------------------|---------------|-----------------|-----------------|------------------|---------------|---------------|-----------------|--------------------------|--------------------------|
| Cash and balances with Central Bank | 256 | 140 | 63 | 23 | 4 | 29 | 32 | 45 | 21 | 36 | 649 |
| Bonds and debt instruments | 19,339 | 9,571 | 28 | - | - | - | 3,256 | - | - | - | 32,194 |
| Shares and equity instruments | 40 | 1,889 | - | - | - | - | 45 | - | - | - | 1,974 |
| Loans to credit institutions | 24,283 | 26,685 | 728 | 234 | 295 | 5,191 | 1,073 | 53 | 713 | 557 | 59,812 |
| Loans to customers | 101,156 | 18,420 | 1,996 | 1,119 | 3,230 | 3 | 4,519 | 599 | 5,693 | 41 | 136,776 |
| Other assets | 894 | 1,889 | 742 | 4 | 62 | 15 | 3 | 23 | 8 | 1,061 | 4,701 |
| Total assets | 145,968 | 58,594 | 3,557 | 1,380 | 3,591 | 5,238 | 8,928 | 720 | 6,435 | 1,695 | 236,106 |
| Liabilities | | | | | | | | | | | |
| Deposits from credit institutions | 5,095 | 388 | - | 4 | 102 | - | - | - | - | - | 5,589 |
| Deposits from customers | 23,377 | 30,666 | 3,419 | 249 | 627 | 681 | 2,443 | 1,479 | 328 | 44 | 63,313 |
| Debt issued and other borrowed funds | 125,623 | - | - | - | - | 22,545 | 6,563 | - | - | - | 154,731 |
| Subordinated loans | - | - | - | - | - | 8,872 | - | - | - | - | 8,872 |
| Other liabilities | 3,170 | 1,739 | 773 | 20 | 174 | 68 | 23 | 147 | 28 | 1,165 | 7,307 |
| Total liabilities | 157,265 | 32,793 | 4,192 | 273 | 903 | 32,166 | 9,029 | 1,626 | 356 | 1,209 | 239,812 |
| Net on-balance sheet position | (11,297) | 25,801 | (635) | 1,107 | 2,688 | (26,928) | (101) | (906) | 6,079 | 486 | (3,706) |
| Net off-balance sheet position | 10,834 | (24,110) | 656 | (1,122) | (2,734) | 27,034 | (171) | 876 | (4,563) | (22) | 6,678 |
| Net position | (463) | 1,691 | 21 | (15) | (46) | 106 | (272) | (30) | 1,516 | 464 | 2,972 |

Notes to the Condensed Consolidated Interim Financial Statements

54. Cont'd

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 | 5,216 | 378 | - | 4 | 4 | - | - | - | - | - | 5,602 |
| Deposits from customers | 22,546 | 24,405 | 4,468 | 190 | 336 | 703 | 2,683 | 2,452 | 358 | 22 | 58,163 |
| 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) |

Notes to the Condensed Consolidated Interim Financial Statements

55. 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.

56. 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.

| Assets, CPI-linked | 30.6.2018 | 31.12.2017 |
|--|----------------|----------------|
| Bonds and debt instruments | 2,035 | 2,442 |
| Loans to customers | 283,217 | 270,533 |
| Off-balance sheet position | 35 | 506 |
| Total assets | 285,287 | 273,481 |
| Liabilities, CPI-linked | | |
| Deposits from customers | 91,407 | 92,077 |
| Debt issued and other borrowed funds | 107,490 | 91,351 |
| Off-balance sheet position | 69,651 | 62,569 |
| Total liabilities | 268,548 | 245,997 |
| CPI imbalance | 16,739 | 27,484 |

57. Capital management

The following table shows the capital base, risk exposure amount, the resulting capital ratios and leverage for the Group at 30 June 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 Authorities the overall capital requirement is 19.8%. The Group's capital target includes a 0.5-1.5% management buffer on top of the overall capital requirement.

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

Notes to the Condensed Consolidated Interim Financial Statements

57. Cont'd

Capital base and risk exposure amount:

| | 30.6.2018 | 31.12.2017 |
|---|------------------|------------------|
| CET1 capital | | |
| Ordinary share capital | 10,000 | 10,000 |
| Share premium | 55,000 | 55,000 |
| Other reserves | 5,598 | 6,179 |
| Retained earnings | 99,159 | 107,387 |
| Non-controlling interests | 2,425 | 2,479 |
| Fair value changes due to own credit standing | 730 | - |
| Tax assets | (374) | (4) |
| Intangible assets | (4,774) | (4,231) |
| Other regulatory adjustments | - | (1,285) |
| Total CET1 capital | 167,764 | 175,525 |
| Tier 2 capital | | |
| Qualifying subordinated liabilities | 8,872 | 9,505 |
| General credit risk adjustments | - | 1,729 |
| Total capital base | 176,636 | 186,759 |
| Risk exposure amount | | |
| - due to credit risk | 724,177 | 682,525 |
| - due to market risk: | 10,055 | 8,102 |
| Market risk, trading book | 6,251 | 6,709 |
| Currency risk | 3,804 | 1,393 |
| - due to credit valuation adjustment | 1,786 | 1,534 |
| - due to operational risk | 83,331 | 83,331 |
| Total risk exposure amount | 819,349 | 775,492 |
| Capital ratios | | |
| CET1 ratio | 20.5% | 22.6% |
| Total capital ratio | 21.6% | 24.1% |
| Leverage ratio | | |
| Exposure amount | | |
| On-balance sheet exposures | 1,103,384 | 1,026,879 |
| Off-balance sheet exposures | 49,551 | 51,328 |
| Derivative exposures | 7,606 | 6,334 |
| Leverage ratio total exposure measure | 1,160,541 | 1,084,541 |
| Tier 1 capital | 167,764 | 175,525 |
| Leverage ratio | 14.5% | 16.2% |