

# **MP Bank hf.**

## Consolidated Financial Statements 31 December 2011

MP Bank hf.  
Ármúli 13a  
108 Reykjavík  
Iceland

Reg. no. 540502-2930

# Contents

Endorsement and Statement by the Board of Directors and the CEO .....	1
Independent Auditor's Report .....	2
Consolidated Income Statement .....	3
Consolidated Statement of Comprehensive Income .....	4
Consolidated Statement of Financial Position .....	5
Consolidated Statement of Changes in Equity .....	6
Consolidated Statement of Cash Flows .....	7
Notes .....	8

# Notes to the Financial Statements

<b>General information</b>	<b>Page</b>	<b>Financial assets and liabilities - classification</b>	<b>Page</b>
1. Reporting entity	8	45. Financial assets and liabilities - accounting classification and fair values	27
2. Basis of preparation	8	46. Financial assets and liabilities measured at fair value	28
<b>Significant accounting policies</b>		<b>Business combinations</b>	
3. Basis of consolidation	9	47. Acquisition of Icelandic and Lithuanian operations of EA fjárfestingarfélag hf.	29
4. Associates	9	48. Acquisition of ALFA verðbréf hf.	31
5. Foreign currency	10	<b>Segments</b>	
6. Interest income and expense	10	49. Operating Segments	32
7. Fee and commission income and expense	10	50. Geographical information	32
8. Net financial income	10	<b>Income statement</b>	
9. Dividend income	10	51. Net interest income (expense)	32
10. Administrative expenses	11	52. Fee and commission income	33
11. Income tax	11	53. Net financial income (loss)	33
12. Financial instruments measured at fair value	11	54. Breakdown of foreign currency exchange difference	33
13. Determination of fair value	11	55. Administrative expenses	33
14. Recognition and derecognition of financial assets and liabilities	12	56. Salaries and related expenses	34
15. Offsetting financial assets and liabilities	12	57. Employment terms for the board of directors and the CEO	34
16. Amortised cost measurement of financial assets and liabilities	12	58. Auditor's fees	34
17. Cash and cash equivalents	12	59. Income tax	34
18. Derivatives	13	60. Special tax on financial institutions	35
19. Fixed income securities	13	61. Quarterly statements (unaudited)	35
20. Shares and other variable income securities	13	<b>Statement of financial position</b>	
21. Securities used for hedging	14	62. Cash and cash equivalents	35
22. Loans	14	63. Fixed income securities	35
23. Impairment	14	64. Shares and other variable income securities	36
24. Intangible assets	15	65. Securities used for hedging	36
25. Property and equipment	16	66. Loans to customers	36
26. Short positions in securities	16	67. Allowance for impairment losses	36
27. Deposits	16	68. Intangible assets	37
28. Borrowings	16	69. Property and equipment	37
29. Other liabilities	17	70. Group entities	37
30. Financial guarantees	17	71. Investment in associates	38
31. Employee benefits	17	72. Other assets	38
32. Share capital	17	73. Short positions in securities	39
33. Fiduciary activities	17	74. Short positions in securities used for hedging	39
34. New standards and interpretations	18	75. Deposits	39
35. Use of estimates and judgement	18	76. Borrowings	39
<b>Risk management</b>		77. Deferred tax asset/liabilities	39
36. Risk management disclosure	18	78. Other liabilities	40
37. Credit risk	19	<b>Other</b>	
38. Liquidity risk	22	79. Related parties	40
39. Currency risk	23	80. Share-based payments	40
40. Interest rate risk	25	81. Equity	41
41. Market risk	25	82. Off-balance sheet obligations	41
42. Exposure towards inflation	26	83. Supreme Court ruling no. 600/2011 on interest rate calculations on loans linked to foreign currencies	42
43. Operational risk	26	84. Events after the reporting date	42
44. Hedging	26		

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

The Consolidated Financial Statements of MP Bank hf. for the year 2011 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and additional Icelandic disclosure requirements. The Consolidated Financial Statements comprise MP Bank hf. and its subsidiaries.

According to the Consolidated Income Statement, loss in 2011 amounted to ISK 484 million. According to the Consolidated Statement of Financial Position, the Bank's equity at the end of the year 2011 amounted to ISK 5,069 million. As at 31 December 2011, the Bank's total assets amounted to ISK 50,109 million. The Tier 1 capital ratio of the Bank was 19.2% but the minimum requirement by law is 8.0%.

The developments of the financials within the year were significant. Loss before tax in first half of 2011 was ISK 681 million, whereas the bank returned a profit of ISK 140 million in the second half of the year and pre-tax profits in the fourth quarter alone were ISK 306 million.

The Bank had no operations during 2010. On 1 April 2011 the Bank signed a contract acquiring the Icelandic and Lithuanian assets and operations of EA Fjárfestingarfélag hf. (formerly MP Bank hf.) and resumed commercial banking activities on 12 April 2011. At the same time the Bank changed its name from nb.is - sparisjóður hf. to MP Bank hf. The acquisition is discussed in further detail in note 47.

The Bank's share capital amounted to ISK 104 million at the beginning of the year. Of that amount the Bank held treasury shares with nominal value of ISK 4 million. The Bank's share capital was increased by ISK 5,450 million during the year and amounted to ISK 5,554 million as at 31 December 2011. The Bank held treasury shares with a nominal value of ISK 4 million as at 31 December 2011.

The number of shareholders at year-end was 51, compared to 1 at the beginning of the year. One shareholder held more than 10% of shares in the Bank, Títan Fjárfestingafélag ehf. with 17.3%.

The Bank's Board of Directors propose that no dividend will be paid in the year 2012 on 2011 operations.

## Corporate Governance

The Board of Directors emphasizes maintaining good corporate governance and following accepted guidelines on corporate governance. The Board has laid down comprehensive rules in which the authority of the Board is defined and its scope of work in conjunction with the CEO. These are „The Rules of Procedures for the Board of MP Bank“. They cover e.g. order at meetings, competence of Board members to participate in individual decisions, confidentiality and information disclosure between CEO and the Board. Majority of Board members are independent of the Bank and there are no executive directors on the Board.

The Board determines compensation for the CEO. The Board of Directors has delegated certain tasks to two subcommittees, the remuneration committee and the audit committee. Each has three members appointed by the Board.

## Statement by the Board of Directors and the CEO

To the best of our knowledge the Consolidated Financial Statements of MP Bank hf. for the year 2011 comply with International Financial Reporting Standards as adopted by the EU, and give a true and fair view of the Bank's assets, liabilities and financial position as of 31 December 2011 and the financial performance of the Bank and changes of cash flows for the year 2011.

Further, in our opinion the Consolidated Financial Statements and the Endorsement of the Board of Directors and the CEO gives a fair view of the development and performance of the Bank's operations and its position and describes the principal risks and uncertainties faced by the Bank.

The Board of Directors and the CEO of the Bank have today discussed the Consolidated Financial Statements for the year 2011 and confirm them by the means of their signatures.

Reykjavík, 28 February 2012.

Board of Directors:

Þorsteinn Pálsson

CEO:

Skúli Mogensen

Hanna Katrín Friðriksson

Sigurður Atli Jónsson

Vilmundur Jósefsson

Mario Espinosa

# Independent Auditor's Report

To the Board of Directors and Shareholders of MP Bank hf.

We have audited the accompanying financial statements of MP Bank hf., which comprise the statement of financial position as at 31 December 2011, the statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

## **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by the EU, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

## **Auditor's Responsibility**

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

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

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

## **Opinion**

In our opinion, the financial statements give a true and fair view of the financial position of MP Bank hf. as at 31 December 31 2011, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.

## **Report on the Board of Directors report**

Pursuant to the legal requirement under Article 106, Paragraph 1, Item 5 of the Icelandic Financial Statement Act No. 3/2006, we confirm that, to the best of our knowledge, the report of the Board of Directors accompanying the financial statements includes the information required by the Financial Statement Act if not disclosed elsewhere in the Financial Statements.

Reykjavík, 28 February 2012.

**KPMG ehf.**

Jón S. Helgason  
Hrafnhildur Helgadóttir

## Consolidated Income Statement for the Year 2011

	Notes	2011	2010
Interest income .....		1,440,943	0
Interest expense .....		(982,218)	(253)
Net interest income (expense)	51	458,725	(253)
Fee and commission income .....	52	847,051	0
Fee and commission expense .....		(71,004)	0
Net fee and commission income		776,047	0
Net financial income (loss) .....	53	492,714	(71)
Share in gain (loss) of associates .....	71	66,128	(29)
Other income .....		36,365	37,417
Net operating income		1,829,979	37,063
Administrative expenses .....	55	(2,126,991)	(2,128)
Impairment losses .....	67	(244,210)	0
(Loss) profit before taxes		(541,221)	34,935
Income tax .....	59	115,602	0
Special tax on financial institutions .....	60	(57,930)	0
(Loss) profit for the year		(483,549)	34,935
(Loss) profit for the period attributable to owners of the Parent .....		(486,005)	34,935
Profit for the period attributable to non-controlling interest .....		2,456	0
(Loss) profit for the year		(483,549)	34,935

The notes on pages 8 to 42 are an integral part of these Consolidated Financial Statements

## Consolidated Statement of Comprehensive Income for the year 2011

	Notes	2011	2010
(Loss) profit for the year .....		(483,549)	34,935
Other comprehensive income:			
Fair value changes in securities classified as available for sale, net of tax .....		141,775	0
Exchange difference on translation of foreign operations .....		(8,478)	0
<b>Total comprehensive (loss) income for the year</b>		<b>(350,252)</b>	<b>34,935</b>
Total comprehensive (loss) income attributable to owners of the Parent .....		(352,708)	34,935
Total comprehensive income attributable to non-controlling interest .....		2,456	0
<b>Total comprehensive (loss) income for the year</b>		<b>(350,252)</b>	<b>34,935</b>

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## Consolidated Statement of Financial Position as at 31 December 2011

	Notes	31.12.2011	31.12.2010
<b>Assets</b>			
Cash and cash equivalents .....	62	11,545,143	0
Derivatives .....		199,571	0
Fixed income securities .....	63	13,678,864	0
Shares and other variable income securities .....	64	1,068,531	100,585
Securities used for hedging .....	65	7,694,837	0
Loans to customers .....	66,67	13,294,303	0
Investment in associates .....	71	405,272	170,955
Intangible assets .....	68	1,123,857	0
Property and equipment .....	69	328,599	0
Deferred tax asset .....	77	107,872	0
Other assets .....	72	662,246	2,614
<b>Total assets</b>		<b>50,109,096</b>	<b>274,153</b>
<b>Liabilities</b>			
Short positions in securities .....	73	4,838,963	0
Short positions in securities used for hedging .....	74	1,274,229	0
Derivatives .....		101,498	0
Deposits .....	75	34,594,083	0
Borrowings .....	76	2,051,155	0
Current tax liabilities .....	77	32,704	0
Deferred tax liabilities .....	77	303	0
Other liabilities .....	78	2,147,207	255,000
<b>Total liabilities</b>		<b>45,040,142</b>	<b>255,000</b>
<b>Equity</b>			
Share capital .....	81	5,550,000	100,000
Share premium .....		7,500	330,000
Translation reserve .....		(8,478)	0
Accumulated deficit .....		(480,076)	(410,847)
<b>Total equity attributable to owners of the Parent</b> .....		<b>5,068,945</b>	<b>19,153</b>
Equity attributable to non-controlling interest .....		9	0
<b>Total equity</b>		<b>5,068,954</b>	<b>19,153</b>
<b>Total liabilities and equity</b>		<b>50,109,096</b>	<b>274,153</b>

The notes on pages 8 to 42 are an integral part of these Consolidated Financial Statements

## Consolidated Statement of Changes in Equity for the year 2011

	Notes	Share capital	Share premium	Translation reserve	Accumulated deficit	Total	Non-controlling interest	Total
2011								
Equity at 1.1.2011 .....		100,000	330,000	0	(410,847)	19,153	0	19,153
Total comprehensive loss for the year		0	0	(8,478)	(344,230)	(352,708)	2,456	(350,252)
New share capital sold .....		5,450,000	7,500			5,457,500		5,457,500
Expenses incurred in relation to share capital increase, net of tax .....					(55,000)	(55,000)		(55,000)
Share premium offset against accumulated deficit .....			(330,000)		330,000	0		0
Non-controlling interest acquired .....	70						(2,447)	(2,447)
Equity at 31.12.2011		5,550,000	7,500	(8,478)	(480,076)	5,068,945	9	5,068,954
2010								
Equity at 1.1.2010 .....		100,000	330,000	0	(406,261)	23,739	0	23,739
Total comprehensive income for the year		0	0	0	34,935	34,935	0	34,935
Cash dividend .....					(39,520)	(39,520)		(39,520)
Equity at 31.12.2010		100,000	330,000	0	(410,847)	19,153	0	19,153

The notes on pages 8 to 42 are an integral part of these Consolidated Financial Statements

## Consolidated Statement of Cash Flows for the Year 2011

	Notes	2011	2010
<b>Cash flows from operating activities</b>			
(Loss) profit for the year		(483,549)	34,935
Adjustments for:			
Indexation and exchange rate difference .....		491,489	0
Effects of associates .....	71	(66,128)	29
Depreciation and amortization .....		111,673	0
Impairment of loans and receivables .....	67	244,210	0
Deferred income tax, change .....	77	(107,784)	0
		189,911	34,964
Loans, change .....		(4,756,632)	0
Deposits, change .....		1,360,123	0
Financial assets, change .....		(1,850,123)	46,335
Financial liabilities, change .....		(1,358,814)	0
Change in operating assets and liabilities .....		(3,335,246)	(37,320)
Net cash (to) from operating activities		(9,750,781)	43,978
<b>Cash flows from investing activities</b>			
Associated companies .....	71	38,408	(263,110)
Investment in property, plant and equipment .....		(51,212)	0
Disposals of property, plant and equipment .....		138,405	0
Investment in intangible assets .....		(301,966)	0
Net cash used in investing activities		(176,365)	(263,110)
<b>Cash flows from financing activities</b>			
Borrowings .....		17,802,155	255,000
Repayment of borrowings .....		(15,751,000)	0
Dividends paid .....		0	(39,520)
New share capital .....		5,402,500	0
Cash flows from financing activities		7,453,655	215,480
Net decrease in cash and cash equivalents .....		(2,473,491)	(3,652)
Cash and cash equivalents at the beginning of the year .....		0	3,652
Cash acquired through business combinations .....	47,48	13,961,738	0
Effects of exchange rate fluctuations on cash held .....		56,897	0
Cash and cash equivalents at the end of the year	62	11,545,143	0

The notes on pages 8 to 42 are an integral part of these Consolidated Financial Statements

# Notes

## General Information

### 1. Reporting entity

MP Bank hf. is a public limited company incorporated and domiciled in Iceland. The Consolidated Financial Statements as at and for the year ended 31 December 2011 comprise MP Bank hf. (the Parent) and its subsidiaries (together referred to as the "Bank") and the Bank's interest in associates. The address of the Bank is Ármúli 13a, Reykjavík. The Bank has offices in Reykjavík and Vilnius, Lithuania.

MP Bank's main purpose is to offer banking services to individuals, corporations and institutional investors. The Bank operates in three areas: Investment Banking, Retail Banking and Asset Management.

### 2. Basis of preparation

#### a. Statement of compliance

The Consolidated Financial Statements of MP Bank hf. for the year 2011 have been prepared in accordance with International Financial Reporting Standards (IFRS) as adopted by the EU.

The Bank's Financial Statements as at and for the year ended 31 December 2010 were prepared in accordance with the Icelandic Financial Statements Act (IS-GAAP). The transition from IS-GAAP to the new accounting policies, IFRS, had no effect on the Bank's equity.

The Consolidated Financial Statements were approved for issue by the Board of Directors on 28 February 2012.

#### b. Significant accounting policies and basis of measurement

The Consolidated Financial Statements have been prepared on the historical cost basis except for derivative financial instruments, financial instruments at fair value through profit or loss, available for sale financial assets and securities used for hedging which are measured at fair value.

#### c. Functional and presentation currency

The Consolidated Financial Statements are prepared in Icelandic Krona (ISK), which is the Bank's functional currency. All financial information has been rounded to the nearest thousand, unless otherwise stated.

#### d. Going concern

The Bank's management has assessed the Bank's ability to continue as a going concern and is satisfied that the Bank has the resources to continue its operations.

#### e. Estimates and judgement

The preparation of interim financial statements in accordance with IFRSs requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

The estimates and underlying assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying amounts of assets and liabilities that are not readily apparent from other sources, actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an on going basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period or in the period if the revision and future periods if the revision affects both current and future periods.

Information about areas of estimation uncertainty and critical judgements made by management in applying accounting policies that can have a significant effect on the amounts recognised in the Consolidated Financial Statements is provided in note 35.

## Notes

### Significant accounting policies

#### 3. Basis of consolidation

##### a. Subsidiaries

Subsidiaries are entities controlled by the Bank. Control exists when the Bank has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control usually exists when the Bank holds more than 50% of the voting power of the subsidiary. In assessing control, potential voting rights that are presently exercisable or convertible, if any, are taken into account. The financial statements of subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Bank. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest. The excess of the cost of acquisition over the fair value of the Bank's share of the identifiable net assets acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised immediately in the income statement.

##### b. Non-controlling interests

Non-controlling interests represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank; such interests are presented separately in the income statement and are included in equity in the statement of financial position, separately from equity attributable to owners of the Bank. The Bank chooses on an acquisition-by-acquisition basis whether to measure non-controlling interests in an acquiree at fair value or according to the proportion of non-controlling interests in the acquiree's net assets. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interests are adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

##### c. Funds management

The Bank manages and administers assets held in mutual funds and pension funds on behalf of investors. The financial statements of these funds are not included in these consolidated financial statements.

##### d. Transactions eliminated on consolidation

Intra-bank balances, income and expenses, and unrealised gains and losses arising from intra-bank transactions, are eliminated in preparing the consolidated financial statements. Unrealised gains arising from transactions with associates are eliminated against the investment to the extent of the Bank's interest in the associate. Unrealised losses are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

#### 4. Associates

Associates are those entities in which the Bank has significant influence, but not control, over the financial and operating policies. Significant influence generally exists when the Bank holds between 20% and 50% of the voting power, including potential voting rights, if any. Investments in associates are initially recognised at cost.

The consolidated financial statements include the Bank's share of the total recognised gains and losses of associates on an equity accounted basis, from the date the significant influence commences until the date it ceases. When the Bank's share of loss exceeds its interest in an associate, the Bank's carrying amount is reduced to zero and recognition of further losses is discontinued except to the extent that the Bank has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the investor resumes recognising its share of those profits only after its share of the profits equals the share of losses not recognised.

## Notes

### 5. Foreign currency

#### a. Foreign currency transactions

Transactions in foreign currencies are translated into the respective functional currency of the operation at the spot exchange rate ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to the functional currency at the foreign exchange rate ruling at the reporting date. Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated at spot exchange rate ruling at the date the fair value was determined.

#### b. Foreign operations

The assets and liabilities of foreign operations, including goodwill and fair value adjustments arising on acquisition, are translated into the functional currency at spot exchange rate current at the reporting date. The income and expenses of foreign operations are translated into the functional currency at the spot exchange rates at the dates of the transactions.

### 6. Interest income and expense

Interest income and expense are recognised in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial asset or liability (or, where appropriate, a shorter period) to the carrying amount of the financial asset or liability. When calculating the effective interest rate, the Bank estimates future cash flows considering all contractual terms of the financial instruments but not future credit losses.

Interest income and expense presented in the income statement include:

- Interest on financial assets and liabilities at amortised cost calculated on an effective interest basis
- Interest income and expense on derivatives

### 7. Fee and commission income and expense

The Bank provides various services to its clients and earns income there from, such as income from transactions on behalf of third parties, commission from customers for equity and bond transactions and other services.

- Fee and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.
- Other fee and commission income is recognised in the income statement as the services are provided. Fees that are performance-linked are recognised when the performance criteria is fulfilled.
- Fee and commission expense relates mainly to transaction fees, which are expensed as the services are received.

### 8. Net financial income

Net financial income is comprised of the following:

- Realised and unrealised gains or losses from price changes of fixed income securities carried at fair value
- Realised and unrealised gains or losses from price changes of variable income securities
- Interest income from fixed income securities carried at fair value
- Dividends, excluding dividends from associates and subsidiaries
- Foreign exchange difference.

### 9. Dividend income

Dividend income is recognised when the right to receive income is established. Usually this is the ex-dividend date for equity securities. Dividends, other than those from associates and subsidiaries, are reflected as component of net financial income.

## Notes

### 10. Administrative expenses

Administrative expenses comprise expenses other than interest expenses, fee and commission expenses and expenses related to fair value changes. A breakdown of administrative expenses is provided in note 55.

### 11. Income tax

Income tax comprises current and deferred tax. Income tax is recognised in the income statement, except to the extent that it relates to items recognised directly in other comprehensive income or equity, in which case it is recognised there.

Tax payable is the estimated tax payable next year on current year's profit according to the tax rates prevailing at reporting date, in addition to corrections on tax from previous years.

The deferred income tax liability has been calculated and recognised in the statement of financial position. The calculation is based on the difference between assets and liabilities as presented in the tax return on one hand, and in the consolidated financial statements on the other, taking into consideration tax losses carried forward. This difference is due to the fact that the tax assessment is based on premises that differ from those governing the consolidated financial statements, mostly due to temporary differences arising from the recognition of revenue and expense in the tax returns and in the consolidated financial statements.

Tax assets and tax liabilities are offset on the statement of financial position when there is a legal right to settle on a net basis and they are levied by the same taxing authority on the same entity or on different entities subject to joint taxation.

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

### 12. Financial instruments measured at fair value

The Bank classifies certain financial assets and financial liabilities upon their initial recognition as financial instruments at fair value through profit or loss.

Financial asset or financial liability is classified as held for trading if it is purchased or incurred with the intention to resell or repurchase within short period of time, or is a part of a portfolio of defined financial instruments managed on a portfolio basis and data shows recent pattern of short-term profit taking. Financial assets held for trading consist of debt instruments, equity instruments and derivatives. Financial liabilities are derivatives and short positions, that is a commitment to deliver financial assets that the Bank has borrowed and sold to third party.

The Bank designates certain financial assets at fair value through profit and loss on initial recognition when these financial assets are part of a portfolio of financial instruments that are managed on the basis of fair value and information provided to management is based on fair value.

### 13. Determination of fair value

The determination of fair value of financial assets and financial liabilities that are quoted in an active market is based on quoted prices. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring market transactions on an arm's length basis. For all other financial instruments fair value is determined by using valuation techniques.

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

## Notes

For more complex instruments, the Bank uses proprietary models, which usually are developed from recognised valuation models. Some or all of the inputs into these models may not be market observable, and are derived from market prices or rates or are estimated based on assumptions. When entering into a transaction, the financial instrument is recognised initially at the transaction price, which is the best indicator of fair value, although the value obtained from the valuation model may differ from the transaction price. This initial difference, usually an increase in fair value, indicated by valuation techniques is recognised in income depending upon the individual facts and circumstances of each transaction and not later than when the market data becomes observable.

The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, because valuation techniques cannot appropriately reflect all factors market participants take into account when entering into a transaction. Valuation adjustments are recorded to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors. Management believes that these valuation adjustments are necessary and appropriate to fairly state financial instruments carried at fair value in the statement of financial position.

### 14. Recognition and derecognition of financial assets and liabilities

#### a. Recognition

The Bank initially recognises loans, deposits, debt securities issued and subordinated liabilities on the date that they are originated. All other financial assets and liabilities (including assets and liabilities designated at fair value through profit or loss) are initially recognised on the trade date at which the Bank becomes a party to the contractual provisions of the instrument.

#### b. Derecognition

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

Financial liabilities are recognised when the Bank becomes a party to the contractual provisions of the liability instrument. Financial liabilities are derecognised when the obligation of the Bank is discharged or cancelled or expires.

### 15. Offsetting financial assets and liabilities

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

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

### 16. Amortised cost measurement of financial assets and liabilities

The amortised cost of a financial asset or liability is the amount at which the financial asset or liability is measured at initial recognition, minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

### 17. Cash and cash equivalents

Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, including cash in hand, balances with banks, unrestricted balances with Central Bank and other short-term highly liquid investments with original maturities of three months or less.

## Notes

### 18. Derivatives

A derivative is a financial instrument or another contract that falls under the scope of IAS 39 and has the following three characteristics:

- its price changes due to changes in an underlying variable, such as share price, commodity price or bond price, index, foreign currency rate or interest rate,
- the contract requires no initial investment or an initial investment that is smaller than would be required for a contract with the same sensitivity to market changes, and
- the contract is settled at a future date.

The Bank uses derivatives for trading purposes and to hedge its exposure to market price risk, foreign exchange risk and interest risk arising from operating, financing and investing activities.

Derivative assets and liabilities are initially recognised and subsequently measured at fair value in the statement of financial position. Revenue from derivatives is split into interest income and net income from financial instruments at fair value and presented in the corresponding line items in the income statement.

### 19. Fixed income securities

Fixed income securities are initially measured at fair value and subsequently accounted for depending on their classification as either trading, fair value through profit or loss, available for sale or held to maturity. If the classification is available for sale or held to maturity the initial recognition includes incremental direct transaction costs.

#### a. Trading

Fixed income securities acquired principally for the purpose of selling or repurchasing in the near term, or holding as part of a portfolio that is managed together for short-term profit or position taking, are classified as trading.

They are subsequently measured at fair value in the statement of financial position, with transaction costs recognised in profit or loss. Interest income and all changes in fair value are recognised as financial income.

#### b. Fair value through profit and loss

Some fixed income securities are designated at fair value through profit and loss, with fair value changes recognised immediately in financial income.

#### c. Available for sale

Fixed income securities designated as available for sale are carried at fair value. Interest income is recognised using the effective interest method with other fair value changes recognised in comprehensive income until the securities are sold, whereupon the cumulative gains and losses previously recognised in other comprehensive income are reclassified to financial income.

#### d. Held to maturity

Held-to-maturity investments are non-derivative assets with fixed or determinable payments and fixed maturity that the Bank has the positive intent and ability to hold to maturity.

Held-to-maturity fixed income securities are carried at amortised cost using the effective interest method. A sale or reclassification of a more than insignificant amount of held to maturity investments would result in the reclassification of all held to maturity investments as available for sale, and would prevent the Bank from classifying investment securities as held to maturity for the current and the following two financial years.

### 20. Shares and other variable income securities

Equity investments and other variable income securities consist of equity investments and unit shares in mutual funds. These investments are initially and subsequently recognised at fair value with price changes recognised in the income statement. Price changes and dividends received are recognised as financial income in the income statement.

## Notes

### 21. Securities used for hedging

Securities used for hedging consist of non-derivative financial assets that are used to hedge the Bank's risk exposure arising from derivative contracts with customers.

### 22. Loans

Loans are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and advances include loans provided by the Bank to its customers, participation in loans from other lenders and purchased loans that are not quoted in an active market and which the Bank has no intention of selling immediately or in the near future.

When the Bank purchases a financial asset and simultaneously enters into an agreement to resell the asset (or a substantially similar asset) at a fixed price on a future date ("reverse repo or stock borrowing"), the arrangement is accounted for as a loan and the underlying asset is not recognised in the Bank's consolidated financial statements.

Loans are initially recognised at fair value, which is the cash advanced, plus any transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in the carrying amount of the loans and advances.

### 23. Impairment

The carrying amount of the Bank's financial assets not at fair value through profit and loss, is reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, the asset's recoverable amount is estimated. An impairment is recognised in the income statement whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

#### a. Impairment on loans

Two methods are used to calculate impairment losses, one based on an assessment of individual loans and the other based on a collective assessment. Losses expected as a result of future events, no matter how likely, are not recognised.

Objective evidence of impairment can be information about the following events:

- i) significant financial difficulty of the borrower;
- ii) a breach of contract, such as a default on instalments or on interest or principal payments;
- iii) the Bank granting to the borrower, for economic or legal reasons relating to the borrower's financial difficulty, a refinancing concession, that the lender would not otherwise consider;
- iv) it becomes probable that the borrower will enter bankruptcy or undergo other financial reorganisation;
- v) the disappearance of an active market for that financial asset because of financial difficulties; or
- vi) observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of loans, even if the decrease cannot yet be identified with the individual financial assets in the group, including:
  - adverse changes in the payment status of borrowers in the group; or
  - general national or local economic conditions connected with the assets in the group.

#### *Individually assessed loans*

Impairment losses on individually assessed loans are determined by an evaluation of the exposures on a case-by-case basis. The Bank assesses at each balance sheet date whether there is any objective evidence that individual loans are impaired. This procedure is applied to all loans that are considered individually significant. In making the assessment, the following factors are considered:

- the Bank's aggregate exposure to the customer;
- the amount and timing of expected receipts and recoveries;
- the likely dividend available on liquidation or bankruptcy;
- the complexity of determining the aggregate amount and ranking of all creditor claims and the extent to which legal and insurance uncertainties are evident;
- the realisable value of security (or other credit mitigants) and likelihood of successful repossession; and
- the likely deduction of any costs involved in recovery of amounts outstanding.

## Notes

Impairment loss is calculated by comparing the carrying amount of individual loans with the present value of their expected future cash flows, discounted at their original effective interest rate. In the case of loans at variable interest rates, the discount rate used is their current effective interest rate. The carrying amount of impaired loans is reduced through the use of an allowance account.

### *Collectively assessed loans*

Where loans have been individually assessed and no evidence of loss has been identified, these loans are grouped together on the basis of similar credit risk characteristics for the purpose of calculating a collective impairment loss. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account:

- future cash flows in a group of loans evaluated for impairment are estimated on the basis of the contractual cash flows of the assets;
- historical loss experience in portfolios of similar risk characteristics, for example, by industry sector, loan grade or product;
- the estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan;
- management's experienced judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience.

Estimates of changes in future cash flows for groups of assets are consistent with changes in observable data from period to period, for example changes in property prices, payment status, or other factors indicative of changes in the probability of losses on the group and their magnitude. The methodology and assumptions used for estimating future cash flows are reviewed regularly by the Bank to minimise any differences between loss estimates and actual losses.

### *Loan write-offs*

Loans are written off, partially or in full, when there is no realistic prospect of recovery.

#### b. Reversal of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is recognised as reduction of cost in the income statement.

#### c. Calculation of recoverable amount

The recoverable amount of the Bank's investments in financial assets carried at amortised cost is calculated as the present value of estimated future cash flows, discounted at the original effective interest rate.

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

## 24. Intangible assets

Separately identifiable intangible assets are recognised at cost. Intangible assets with finite useful life are amortized using the straight-line method over their estimated useful economic life. At each date of the consolidated statement of financial position, intangible assets are reviewed for indications of impairment or changes in estimated future economic benefits. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable. An impairment loss is recognized if the carrying amount exceeds the recoverable amount. The Bank chooses to use the cost model for the measurement after recognition. The estimated useful life of intangible assets is as follows:

Software .....	5-10 years
Other intangible assets with finite useful life .....	10 years

## Notes

### a. Software

Software comprise acquired software licences.

### b. Other intangible assets

Other intangible assets comprise licences and trademarks used in the operation of the Bank.

### c. Goodwill

Goodwill arises on the purchase of banking operations from EA fjárfestingarfélag hf. and subsidiaries and equals the difference between the purchase price and share in the net assets of the acquired company. Net assets include book equity and the revaluation of assets and liabilities, if relevant, and the value of off-balance sheet assets and liabilities. Following initial recognition, goodwill is recognised at cost, less impairment. At each reporting date, indications of impairment are evaluated. If such indications exist an analysis takes place in order to estimate the need for an impairment charge.

## 25. Property and equipment

### a. Recognition and measurement

Property and equipment is recognised at cost less accumulated depreciation and impairment. The cost includes direct expenses associated with the purchase.

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

### b. Subsequent costs

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

### c. Depreciation

Depreciation is recognised in the income statement on a straight-line basis over the estimated useful lives of each component of an item of property and equipment. The estimated useful lives are as follows:

Real estate .....	50 years
Office equipment and fixtures .....	3-5 years

Depreciation methods, useful lives and residual value are reassessed annually.

## 26. Short positions in securities

Short positions are carried at fair value with all fair value changes recognised in the income statement under net financial income.

## 27. Deposits

Deposits consist of time deposits and demand deposits. Deposits are recognised at amortised cost, including accrued interests.

## 28. Borrowings

When the Bank sells a financial asset and simultaneously enters into a "repo" or "stock lending" agreement to repurchase the asset (or a similar asset) at a fixed price on a future date, the arrangement is accounted for as a deposit, and the underlying asset continues to be recognised in the Bank's consolidated financial statements.

Borrowings are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

## Notes

### 29. Other liabilities

Other liabilities are measured at cost.

### 30. Financial guarantees

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

Financial guarantee liabilities are initially recognised at their fair value, and initial fair value is amortised over the life of the financial guarantee. The guarantee liability is subsequently carried at the higher of this amortised amount and the present value of any expected payment, when a payment under the guarantee has become probable. Financial guarantees are included within other liabilities.

### 31. Employee benefits

Obligations for contributions pension plans are recognised as an expense in profit or loss when they are due.

### 32. Share capital

#### a. Treasury shares

Acquired own shares and other equity instruments (treasury shares) are deducted from equity. No gain or loss is recognised in income statement on the purchase, sale, issue or cancellation of treasury shares. Consideration paid or received is recognised directly in equity.

Incremental transaction costs of treasury share transactions are accounted for as a deduction from equity, net of any related income tax benefit.

When classifying a financial instrument, or component of it, in the consolidated financial statements, all terms and conditions agreed between the Bank and the holders of the instrument are considered. To the extent there is an obligation that would give rise to a financial liability, the instrument is classified as financial liability, rather than an equity instrument.

When share capital is repurchased, the amount of the consideration paid, including directly attributable costs, is recognised as a change in capital.

#### b. Share premium

Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Bank. According to Icelandic Companies Act, 25% of the nominal value of share capital must be held in reserve which can not be paid out as dividend to shareholders.

#### c. Translation reserve

Foreign exchange differences arising on translation of financial statements of foreign operations are recognised directly in a separate component of equity. When a foreign operation is disposed of, in part or in full, the relevant amount in the translation reserve is transferred to profit or loss.

#### d. Dividends on share capital

Dividends on share capital are deducted from equity in the period in which they are approved by the Bank's shareholders meetings.

### 33. Fiduciary activities

The Bank provides custody services, fund management and discretionary and advisory investment management services which require the Bank to make decisions on the handling, acquisition or disposal of financial instruments. Assets that the Bank holds or invests on behalf of its clients are not reported in the consolidated financial statements, since they do not comprise Bank assets.

## Notes

### 34. New standards and interpretations

A number of new standards, amendments to standards and interpretations are not yet effective for the year ended 31 December 2011 and have not been applied in preparing these financial statements. None of them will have material effect on the financial statements with the exception of IFRS 9 Financial instruments, which if endorsed by the EU will be mandatory for the Bank for the first time for the year 2015. Its adoption can affect the classification and valuation of financial assets and financial liabilities. Early adoption of the standard is not planned and the effects of the adoption have not been estimated.

### 35. Use of estimates and judgement

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

#### a. Impairment losses on loans

The management reviews its loan portfolios to assess impairment at least on a three months basis. In determining whether an impairment loss should be recorded in the income statement, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there have been changes in the payment status of borrowers in a group or economic conditions. Management uses estimates based on historical loss experience for assets with similar credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

#### b. Deferred tax asset

The value of a deferred tax asset is estimated by management, based on projections about future profits and the extent to which the tax asset will be realised.

#### c. Fair value of financial instruments

The fair value of financial instruments that are not quoted in active markets are determined by using valuation techniques which are reviewed regularly by qualified independent personnel. All models that are used must be approved and calibrated to ensure that outputs reflect actual data.

### 36. Risk management disclosure

#### *Committees*

The Bank operates an Asset and Liability Committee (ALCO), a credit committee and a security and IT committee.

On the Bank's ALCO committee are the CEO, managing director of investment banking, managing director of capital markets, head of risk management and head of treasury. The ALCO committee meets regularly and each department reports on its operations and positions activity since the previous meeting. The committee addresses matters regarding the Bank's risk management, financing, capital management and proprietary trading.

The credit committee consists of the Bank's CEO, managing director of retail banking, managing director of investment banking, head of risk management, head of credit department and head of legal. The CEO shall decide whether any other employees should attend the meetings. The committee addresses matters regarding the Bank's loan activities. The committee is responsible for the approval of individual loans as well as deciding on credit limits for individual clients in derivative trades. The committee is the primary forum for the discussion of loan activity policy.

The security and IT committee is responsible for supervision and implementation of information security policy of the Bank. Members are the COO, managing director of retail banking and head of risk management.

## Notes

### *Risk management and credit control unit*

The purpose of the risk management and credit control unit is to identify, quantify, control and report on the risks that the Bank is exposed to in its daily activities. The unit also participates in drafting the overall risk policy of the Bank and has representatives on the ALCO committee and the security and IT committee. The unit's main activities include monitoring and managing credit risk, market risk, liquidity risk and operational risk. The board of directors sets the rules and guidelines regarding the Bank's risk policy and the obligations of risk management and credit control. The division reports regularly to the board of directors, the CEO and to the ALCO committee on the Bank's positions and exposure to risk.

### *Internal auditor*

Internal auditor has the role to give objective opinion on the Bank's operations and advisory that aims to increase its value. The operation aims to strengthen risk management and control. The tasks of internal audit and main emphasis are to estimate whether processes and systems are in place, whether they are relevant and efficient. Internal auditor is recruited by the board and is located accordingly in the hierarchy. It's operations cover all units of operations, including subsidiaries.

## 37. Credit risk

One of the Bank's primary sources of risk is credit risk. Counterparty credit risk means that if one or more borrowers fail to meet their financial obligations towards the Bank, the Bank has to recognise losses due to these defaults. To a very large extent the Bank's loan portfolio consists only of senior loans, most of which are highly collateralized.

### a. Credit approval process

The originating department prepares a proposal for each loan or credit line which is presented to the credit committee for approval. The proposal consists of a basic description of the client, the purpose of the loan, a simple credit assessment and arguments for or against granting the loan. The committee decides whether there is need for further credit assessment and on what terms the loan may be granted.

A more thorough credit assessment may be conducted if considered appropriate and can include an assessment of a borrower's fundamental credit strength as well as the value of any collateral. To assess the borrower's capacity to meet his or her obligations the committee can request stress test analysis of the borrower's cash flow or call for third party assessments.

### b. Credit collateral

Securing loans with collateral is a traditional method to reduce credit risk. The Bank uses different methods to reduce credit risk by obtaining collateral from customers where appropriate. Such collateral gives the Bank right to the collateralised assets for current and future obligations incurred by the customer.

The Bank places emphasis on ensuring that loans are secured with collateral that can be marked to market, and that asset coverage exceeds 100%, e.g. Senior I loans. The Bank applies appropriate haircuts on all collateral in listed securities in order to ensure proper risk mitigation. For all collateral in listed securities, the Bank maintains the right to liquidate collateral in case its market value falls below the predefined limit.

### c. Credit rating, control and provisioning

The risk management and credit control unit is responsible for credit rating and reviewing the loan portfolio. In case of any significant delay of payments or defaults the unit carefully analyses the underlying assets and loan documents and organizes the process of collection.

The Bank monitors the value of collateral by listed securities on a real time basis, and takes prompt action when necessary.

Provisioning for loan impairments is estimated on the basis of models assessing a portfolio as a whole based on the seniority of the loans, the degree of collateralisation and the Bank's history of defaulted loans. Risk management and credit control suggest a provisioning percentage for the portfolio, based on the expected loss assessment. Risk management and credit control reassess impairments in the event of collateral decay, delayed payments or other early warning signs. Provisions require approval by the CEO and the credit committee.

## Notes

### d. Loan portfolio management

To ensure an effective diversification of the loan portfolio the board has set a limit framework defining maximum exposure as a ratio of the Bank's equity and/or the total size of the loan portfolio. These limits include limitation on joint exposure to associated clients, exposure to individual and associated industries, single regions and countries etc. It is the responsibility of risk management and credit control to monitor that these limits are not being violated and to report discrepancies to the loan committee.

### e. Derivatives

The Bank offers derivative contracts in the form of swap contracts on listed, highly liquid securities. On the day when the contract is entered into, the Bank purchases the underlying security and hedges its exposure to price changes. Collateral is in the form of cash or listed, highly liquid securities. The Bank's risk management sets rules about the level of collateralisation and monitors the compliance to these rules. Contracts are closed if required levels of collateralisation are not met.

### f. Securities used for hedging

The Bank hedges itself for market risk of derivative contracts by purchasing the underlying securities at the commencement of the contract. Since the contracts require delivery of the underlying securities to the customer on the settlement day, the credit risk towards the issuer is immaterial.

### g. Maximum exposure to credit risk

Maximum exposure to credit risk of on-balance sheet and off-balance sheet financial instruments, before taking account of any collateral held or other credit enhancements, is as follows:

	31.12.2011	31.12.2010
Cash and cash equivalents .....	11,545,143	0
Derivatives .....	199,571	0
Fixed income securities .....	13,678,864	0
Shares and other variable income securities .....	583,654	0
Securities used for hedging .....	6,967,719	0
Loans to customers .....	13,294,303	0
Other assets .....	662,246	2,614
<b>Total</b>	<b>46,931,500</b>	<b>2,614</b>

In addition to the above the Bank had entered into loan commitments of ISK 6,046 million. The Bank had also issued financial guarantee contracts for which the maximum amount payable by the bank, assuming all guarantees are called on, is ISK 160 million.

### h. Breakdown of financial assets not at fair value

Financial assets not measured at fair value, exposed to credit risk, are as follows:

31 December 2011	Neither past due nor individually impaired	Past due but not individually impaired	Individually impaired	Gross	Less specific allowance for impairment	Less collective allowance for impairment	Net carrying amount
Cash and cash equivalents .....	11,545,143			11,545,143			11,545,143
Fixed income securities .....	9,245,989			9,245,989			9,245,989
Loans to individuals .....	2,383,753	187,501	62,747	2,634,001	(52,137)	(4,710)	2,577,154
Loans to corporations .....	10,305,628	307,381	255,690	10,868,699	(100,331)	(51,219)	10,717,149
Other assets .....	662,246			662,246			662,246
<b>Total</b>	<b>34,142,758</b>	<b>494,883</b>	<b>318,436</b>	<b>34,956,078</b>	<b>(152,467)</b>	<b>(55,929)</b>	<b>34,747,681</b>

## Notes

31 December 2010

Other assets .....	2,614			2,614			2,614
Total	2,614	0	0	2,614	0	0	2,614

Past due but not impaired financial assets are those assets where contractual payments are past due but the Bank believes that impairment is not appropriate on the basis of the level of security, or future cash flows of the borrower. Past due loans are reported as the total loan and not only the payments that are past due.

i. Breakdown of the loan portfolio by industry sectors

	Individuals	Holding companies	Services	Loans to banks	Other	Total
31.12.2011 .....	2,577,154	3,013,221	4,964,494	0	2,739,434	13,294,303
31.12.2010 .....	0	0	0	0	0	0

j. Breakdown of loans by seniority

The Bank's loan portfolio mainly consists of senior I loans which are secured with collateral which can be marked to market, and have asset coverage exceeding 100% and senior II loans which have first priority claims on the borrower's assets, and in some cases collateral such as unlisted shares and other collateral which cannot be marked to market. The loan portfolio contains less than 25% of junior loans which have second line claims on the borrower's assets and loans where the loan is unsecured and subordinated to all of the borrower's liabilities.

k. Collateral held as security

The Bank's policy is to sell foreclosed assets as soon as possible. These assets are not shown separately in the Bank's accounts but included among other similar assets. The Bank did not take possession of collateral held as security in 2010 or 2011.

l. Large exposures

Total exposure of a customer or a related party is classified as a large exposure if it exceeds 10% of the Bank's equity, net of collateralised assets, in accordance with the Financial Supervisory Authority's regulation no. 216/2007 on financial institutions' large exposures. According to these rules, no single exposure can exceed 25% of equity.

31 December 2011	Number	Amount
Large exposures above 10% but less than 20% of equity .....	3	1,627,123

The Bank had no large exposures in 2010.

## Notes

### 38. Liquidity risk

Liquidity risk is the risk that the Bank will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities, or will only be able to do so substantially above the prevailing market cost of funds. This risk mainly arises from mismatches in the timing of cash flows. The Bank has internal rules that require certain matching of the maturities of assets and liabilities. Furthermore, to ensure the sufficiency of funds, the Bank has lines of credit, overdraft facilities and highly liquid securities such as treasury bills and treasury bonds.

Liquidity is managed by treasury and monitored by risk management. Liquidity position is reported to the ALCO committee. The Bank is subject to the Central Bank's requirements about minimum coverage ratio between cash flows of assets and liabilities. The Bank was in compliance with external liquidity requirements throughout the period.

The table below shows the contractual maturity for both on- and off-balance sheet items. The analysis is based on contractual maturity in accordance with IFRS 7. The table does not take future interest payments into account and therefore doesn't fully reflect future cash flows.

Furthermore, since the table is based on contractual maturities it doesn't fully reflect the liquid nature of market securities which can be converted to cash through repo transactions. Such securities amounted to ISK 13.1 billion on the reporting date and could be converted to cash within two days.

31 December 2011

Financial assets excluding derivatives	0-1 months	1-3 months	3-12 months	1-5 years	Over 5 years	No stated maturity	Total
Cash and cash equivalents .....	11,545,143		53	513,267	12,755,288	711	11,545,143
Fixed income securities .....	306,685	102,861	53	513,267	12,755,288	711	13,678,864
Shares and other variable income securities .....						1,068,531	1,068,531
Securities used for hedging .....				269,794	6,656,888	768,155	7,694,837
Loans to customers .....	5,610,944		3,354,010	3,042,327	1,287,022		13,294,303
Other assets .....	411,816	26,845	20,320			203,264	662,246
<b>Total</b>	<b>17,874,589</b>	<b>129,705</b>	<b>3,374,383</b>	<b>3,825,388</b>	<b>20,699,198</b>	<b>2,040,661</b>	<b>47,943,925</b>
Derivatives .....	101,183	10,686	87,702				199,571
<b>Total</b>	<b>17,975,772</b>	<b>140,391</b>	<b>3,462,085</b>	<b>3,825,388</b>	<b>20,699,198</b>	<b>2,040,661</b>	<b>48,143,496</b>
Financial liabilities excluding derivatives	0-1 months	1-3 months	3-12 months	1-5 years	Over 5 years	No stated maturity	Total
Short positions in securities .....			3,801,395	530,866	506,261	442	4,838,963
Short positions in securities used for hedging .....			458,543	815,686			1,274,229
Deposits .....	28,043,037	2,870	4,626,824	1,868,469	52,883		34,594,083
Borrowings .....	2,051,155						2,051,155
Other liabilities .....	1,721,122	226,766	199,318				2,147,207
<b>Total</b>	<b>31,815,314</b>	<b>229,636</b>	<b>9,086,080</b>	<b>3,215,021</b>	<b>559,144</b>	<b>442</b>	<b>44,905,637</b>
Derivatives .....	94,465	7,033					101,498
<b>Total</b>	<b>31,909,779</b>	<b>236,669</b>	<b>9,086,080</b>	<b>3,215,021</b>	<b>559,144</b>	<b>442</b>	<b>45,007,135</b>
Loan commitments .....	699,346		4,442,079	669,036	235,824		6,046,285
<b>Net assets (liabilities)</b>	<b>(13,934,007)</b>	<b>(96,278)</b>	<b>(5,623,995)</b>	<b>610,367</b>	<b>20,140,054</b>	<b>2,040,220</b>	<b>3,136,361</b>

## Notes

31 December 2010

Financial assets excluding derivatives	0-1 months	1-3 months	3-12 months	1-5 years	Over 5 years	No stated maturity	Total
Shares and other variable income securities .....						100,585	100,585
Other assets .....						2,614	2,614
<b>Total</b>						<b>103,198</b>	<b>103,198</b>
Derivatives .....							0
<b>Total</b>						<b>103,198</b>	<b>103,198</b>
Financial liabilities excluding derivatives	0-1 months	1-3 months	3-12 months	1-5 years	Over 5 years	No stated maturity	Total
Other liabilities .....						255,000	255,000
<b>Total</b>						<b>255,000</b>	<b>255,000</b>
Derivatives .....							0
<b>Total</b>						<b>255,000</b>	<b>255,000</b>
Loan commitments .....							0
<b>Net liabilities</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>(151,802)</b>	<b>(151,802)</b>

## 39. Currency risk

Currency risk arises when financial instruments are not denominated in the reporting currency and can both affect the Bank's income and statement of financial position. A substantial part of the Bank's financial assets and liabilities is denominated in foreign currencies. Any mismatch between assets and liabilities in each currency is monitored closely and managed within limits. Currency positions are monitored by risk management and reported to the ALCO committee.

The Bank is subject to limits set by the Central Bank of Iceland regarding the maximum open currency position. At 31 December 2011 the Bank's position in foreign currencies exceeded those limits. The Bank is working in collaboration with the Central Bank on a program to gradually decrease the currency position.

The following currency exchange rates have been used by the Bank in the preparation of the financial statements:

	31.12.2011	31.12.2010	Average 2011	Average 2010
EUR/ISK .....	158.8	153.8	161.5	162.0
GBP/ISK .....	189.4	178.5	186.1	188.6
USD/ISK .....	122.7	115.1	116.0	122.0
LTL/ISK .....	46.0	44.5	46.8	47.7
ISK trade index .....	217.3	208.0	216.8	216.3

## Notes

## a. Breakdown of financial assets and liabilities by currency:

**31 December 2011**

Assets	EUR	USD	LTL	NOK	Other currencies	Total
Cash and cash equivalents .....	514,552	625,072	13,538	93,804	206,039	1,453,006
Derivatives .....	51,407	934,025		4,448		989,880
Fixed income securities .....	320,486		711	102,861		424,058
Shares and other variable income securities .....	715	66,282	2		89,172	156,171
Securities used for hedging .....	107,635	2,637		1,053		111,325
Loans to customers .....	638,725	882,338	343,534		217,970	2,082,567
<b>Total</b>	<b>1,633,520</b>	<b>2,510,353</b>	<b>357,786</b>	<b>202,166</b>	<b>513,181</b>	<b>5,217,005</b>

  

Liabilities	EUR	USD	LTL	NOK	Other currencies	Total
Short positions .....	6	307		128		442
Derivatives .....	317,680	306,775			159,021	783,476
Deposits .....	1,986,875	1,715,391		194,448	135,883	4,032,596
Borrowings .....						0
<b>Total</b>	<b>2,304,561</b>	<b>2,022,473</b>	<b>0</b>	<b>194,576</b>	<b>294,904</b>	<b>4,816,513</b>

  

Net balance sheet position .....	(671,041)	487,880	357,786	7,589	218,277	400,492
Net off-balance sheet position .....						0
<b>Net position</b>	<b>(671,041)</b>	<b>487,880</b>	<b>357,786</b>	<b>7,589</b>	<b>218,277</b>	<b>400,492</b>

As at 31 December 2010 the Bank had neither assets nor liabilities denominated in currencies other than ISK.

## b. Sensitivity analysis

10% change in the value of the ISK would, with other things constant, cause the following changes to the Bank's pre-tax profit, according to balance sheet position.

	31 December 2011		31 December 2010	
	-10%	+10%	-10%	+10%
EUR .....	67,104	(67,104)	0	0
USD .....	(48,788)	48,788	0	0
LTL .....	(35,779)	35,779	0	0
NOK .....	(759)	759	0	0
Other currencies .....	(21,828)	21,828	0	0
<b>Total</b>	<b>(40,049)</b>	<b>40,049</b>	<b>0</b>	<b>0</b>

Effect on equity would be the same, net of income tax.

## Notes

### 40. Interest rate risk

The Bank's exposure to interest rate risk is twofold. On one hand, the Bank has a proprietary portfolio of bonds, where market rates affect prices and any fluctuations are recognised in the income statement. On the other hand, the Bank has mismatch in assets and liabilities with fixed interest terms in the banking book. The banking book generally pertains to the Bank's loans and swap contracts for securities on the asset side and borrowings and deposits on the liability side. This mismatch does not create immediate effect on the income statement but nevertheless affects the Bank's economic value.

The Bank takes measures to minimise interest rate risk in the banking book by matching the interest rate profile and duration of assets with the Bank's liabilities. This is obtained in part by matching the currency and duration of the funding of the Bank with its assets, as well as using derivative and non-derivative financial instruments to manage effectively the risk of an adverse impact on the Bank's earnings. Proprietary positions which are subject to interest rate risk fall under the scope of the Bank's market risk management.

The table below breaks down assets and liabilities in the banking book according to their interest repricing time for variable interest securities or by maturity date for fixed interest securities, in each currency:

31 December 2011

Assets	ISK	EUR	USD	Other	Total
0-1 year .....	18,921,570	444,586	7,999	3,753	19,377,908
1-2 years .....	1,750		636,619		638,369
2-3 years .....	2,000,000				2,000,000
3-4 years .....	4,400				4,400
over 4 years .....	10,034,515				10,034,515
<b>Total</b>	<b>30,962,235</b>	<b>444,586</b>	<b>644,618</b>	<b>3,753</b>	<b>32,055,192</b>
<b>Liabilities</b>					
0-1 year .....	36,942,807	1,979,494	1,708,091	330,070	40,960,463
<b>Total</b>	<b>36,942,807</b>	<b>1,979,494</b>	<b>1,708,091</b>	<b>330,070</b>	<b>40,960,463</b>
<b>Net imbalance</b>	<b>(5,980,572)</b>	<b>(1,534,908)</b>	<b>(1,063,473)</b>	<b>(326,317)</b>	<b>(8,905,270)</b>

As at 31 December 2010 the Bank had neither interest bearing assets nor interest bearing liabilities.

### 41. Market risk

Market risk constitutes risk due to changes in market prices of instruments and interest rates. The Bank has a strict policy on controlling the market risk and to keep the exposure within the limit framework. The risk management unit follows the market risk limits daily and reports regularly to the Asset and Liability Committee (ALCO) and to the CEO.

#### a. Market price risk

Market price risk arises from changes in the market values of equities in the Bank's portfolio, the size of which varies greatly. The Bank invests primarily in equities listed on regulated securities markets, but has also invested in unlisted equities and bonds. The Bank's risk is the general risk involved in investing in equities. Efforts are made to reduce this risk through active risk management. The risk management monitors the market price risk and reports regularly to the ALCO and to the CEO.

## Notes

- b. Interest rate risk associated with proprietary positions is summarised below. The table shows proprietary positions broken down by remaining maturity, or time until interest rate reset, if shorter.

31 December 2011

Assets	< 1 year	1-3 years	3-5 years	5-7 years	> 7 years	Total
Bonds in ISK .....	274,325	593,554	513,114	12,189,920	749,184	14,320,097
Bonds in foreign currencies .....	102,861					102,861
<b>Total</b>	<b>377,185</b>	<b>593,554</b>	<b>513,114</b>	<b>12,189,920</b>	<b>749,184</b>	<b>14,422,958</b>
<b>Liabilities</b>						
Bonds in ISK .....	4,076,847	1,090,510	33,757	280,119	437,246	5,918,479
<b>Total</b>	<b>4,076,847</b>	<b>1,090,510</b>	<b>33,757</b>	<b>280,119</b>	<b>437,246</b>	<b>5,918,479</b>

As at 31 December 2010 the Bank had neither interest bearing assets nor interest bearing liabilities.

### 42. Exposure towards inflation

Risk towards inflation is the risk that fluctuations in the Icelandic Consumer Price Index (CPI) will affect the balance and cash flow of indexed financial instruments.

The bank controls its indexation risk through sales and purchases of indexed bonds, mostly government bonds, and thus keeps its inflationary position within the limits set by the ALCO.

The Bank is exposed to Icelandic inflation since CPI indexed liabilities exceed CPI indexed assets. All indexed assets and liabilities are valued according to the CPI measure at any given time and changes in CPI are recognised in the income statement as interest. The balance of CPI linked assets and liabilities is specified as follows:

	31.12.2011	31.12.2010
Icelandic government bonds .....	2,732,286	0
Other Icelandic bonds .....	33,672	0
Loans to customers .....	1,440,903	0
Derivatives .....	2,042,561	0
Liabilities .....	(7,061,369)	0
<b>Net inflation exposure</b>	<b>(811,948)</b>	<b>0</b>

### 43. Operational risk

The risk involved in the Bank's operations is primarily linked to the risks inherent in each type of security in which the Bank invests, although there are several other factors which can also affect its operations and performance, such as incorrect analysis of investment options, employee negligence, violations of rules, problems with information systems and loss of key personnel. The Bank's reputation may be damaged, either for the above reasons or as a result of other factors which are difficult to control.

Operational risk can be reduced through staff training, process re-design and enhancement of the control environment. The risk management and credit control unit monitors the operational risk by tracking loss events, quality deficiencies, potential risk indicators and other early-warning signals. The unit takes an active role in internal control and quality management.

### 44. Hedging

A part of the Bank's portfolio consists of securities held as a hedge against derivatives positions of customers. The Bank hedges currency exposure between the Bank's loan portfolio and debts to the extent possible, but possibilities to fully hedge this exposure have been limited since late 2008 due to currency restrictions. The Bank does not use hedge accounting.

## Notes

## 45. Financial assets and liabilities - accounting classification and fair values

The table below sets out the Bank's classification of each class of financial assets and liabilities.

31 December 2011								
Financial assets	Trading	Designated at fair value	Held to maturity	Loans and receivables	Available for sale	Other at amortized cost	Total carrying amount	Fair value
Cash and cash equivalents .....				11,545,143			11,545,143	11,545,143
Derivatives .....	199,571						199,571	199,571
Fixed income securities .....	1,418,908	203,144	9,245,989		2,810,823		13,678,864	14,173,387
Shares and other variable income securities .....	844,084	224,447					1,068,531	1,068,531
Securities used for hedging .....		7,694,837					7,694,837	7,694,837
Loans to customers .....				13,294,303			13,294,303	13,294,303
Other assets .....				662,246			662,246	662,246
<b>Total</b>	<b>2,462,563</b>	<b>8,122,428</b>	<b>9,245,989</b>	<b>25,501,692</b>	<b>2,810,823</b>	<b>0</b>	<b>48,143,496</b>	<b>48,638,019</b>
<b>Financial liabilities</b>								
Short positions in securities .....	4,838,963						4,838,963	4,838,963
Short positions in securities used for hedging .....		1,274,229					1,274,229	1,274,229
Derivatives .....	101,498						101,498	101,498
Deposits .....						34,594,083	34,594,083	34,594,083
Borrowings .....						2,051,155	2,051,155	2,051,155
Other liabilities .....						2,147,207	2,147,207	2,147,207
<b>Total</b>	<b>4,940,461</b>	<b>1,274,229</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>38,792,445</b>	<b>45,007,135</b>	<b>45,007,135</b>
<b>31 December 2010</b>								
Financial assets	Trading	Designated at fair value	Held to maturity	Loans and receivables	Available for sale	Other at amortized cost	Total carrying amount	Fair value
Shares and other variable income securities .....		100,585					100,585	100,585
Other assets .....				2,614			2,614	2,614
<b>Total</b>	<b>0</b>	<b>100,585</b>	<b>0</b>	<b>2,614</b>	<b>0</b>	<b>0</b>	<b>103,198</b>	<b>103,198</b>
<b>Financial liabilities</b>								
Other liabilities .....						255,000	255,000	255,000
<b>Total</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>255,000</b>	<b>255,000</b>	<b>255,000</b>

## Notes

### 46. Financial assets and liabilities measured at fair value

#### Fair value hierarchy

IFRS 7 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources; unobservable inputs reflect the Group's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities. This level includes listed equity securities and debt instruments on exchanges (for example, London Stock Exchange, Frankfurt Stock Exchange, New York Stock Exchange) and exchanges traded derivatives like futures (for example, Nasdaq, S&P 500).
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). This level includes the majority of the OTC derivative contracts, traded loans and issued structured debt. The sources of input parameters like LIBOR yield curve or counterparty credit risk are Bloomberg and Reuters.
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes equity investments and debt instruments with significant unobservable components.

This hierarchy requires the use of observable market data when available. The Bank considers relevant and observable market prices in its valuations where possible.

31 December 2011	Level 1	Level 2	Level 3	Total
Financial assets held for trading:				
Derivatives .....		199,571		199,571
Fixed income securities .....	1,418,908			1,418,908
Shares and other variable income securities .....	807,507	36,578		844,084
Financial assets designated at fair value:				
Fixed income securities .....			203,144	203,144
Shares and other variable income securities .....			224,447	224,447
Securities used for hedging .....	7,694,837			7,694,837
Financial assets available for sale:				
Fixed income securities .....	2,810,823			2,810,823
<b>Total assets</b>	<b>12,732,074</b>	<b>236,149</b>	<b>427,591</b>	<b>13,395,815</b>
Financial liabilities held for trading:				
Derivatives .....		101,498		101,498
Short positions in securities .....	4,838,963			4,838,963
Short positions in securities used for hedging .....	1,274,229			1,274,229
<b>Total liabilities</b>	<b>6,113,192</b>	<b>101,498</b>	<b>0</b>	<b>6,214,690</b>

31 December 2010	Level 1	Level 2	Level 3	Total
Financial assets designated at fair value:				
Shares and other variable income securities .....			100,585	100,585
<b>Total assets</b>	<b>0</b>	<b>0</b>	<b>100,585</b>	<b>100,585</b>

As at 31 December 2010 the Bank had no financial liabilities measured at fair value.

## Notes

### 47. Acquisition of Icelandic and Lithuanian operations of EA fjárfestingarfélag hf.

Through a contract dated 1 April 2011, endorsed by the seller's shareholders' meeting on 11 April 2011, the Bank acquired the Icelandic and Lithuanian operations of EA fjárfestingarfélag hf. (formerly MP Bank hf.) and the assets and trademarks used in those operations. The operations acquired include banking services to individuals, corporates, and institutional investors in the areas of lending, deposit taking, brokerage services, capital markets, asset management and fund management.

In the period 12 April to 31 December 2011 the acquired operations contributed Net operating income of ISK 1,844 million and loss of ISK 469 million. If the acquisition had occurred on 1 January 2011, management estimates that consolidated Net operating income would have been ISK 2,397 million and consolidated loss for the period would have been ISK 682 million. In determining these amounts, management has assumed that the fair value adjustments, determined provisionally, that arose on the date of acquisition would have been the same if the acquisition had occurred on 1 January 2011.

#### a. Consideration transferred

In addition to operations the acquisition included the assets and trademarks used in those operations. The assets acquired included cash and cash equivalents, securities, loan portfolio, shares in subsidiaries and associates, fixed and intangible assets and receivables related to assets and operations acquired.

The purchase price was paid in full through the assumption of debt, primarily in the form of deposits, short positions in securities and payables related to the assets and operations acquired. As assumed debt exceeded the purchase price the difference was settled with a loan from the Bank to the seller.

The value of individual assets and liabilities was determined through negotiations between seller and buyer at arms length and as such is thought to represent fair value. According to the conditions of the contract, financial risk related to assets and liabilities acquired was generally transferred to the buyer as of 1 March 2011 but for some assets the transfer date was set at 1 January 2011. Fair value changes from the time the transfer of risk takes place until formal transfer of ownership on 12 April 2011 are reflected in the book value of goodwill associated with the acquisition.

#### b. Identifiable assets acquired and liabilities assumed

The acquisition had the following effect on the Bank's Statement of Financial Position:

	Pre- acquisition	Acquired	Post- acquisition
<b>Assets</b>			
Cash and cash equivalents .....		13,945,540	13,945,540
Derivatives .....		248,201	248,201
Fixed income securities .....		5,165,718	5,165,718
Shares and other variable income securities .....	100,585	876,145	976,729
Securities used for hedging .....		14,259,257	14,259,257
Loans to customers .....		8,362,345	8,362,345
Investment in associates .....	170,955	201,280	372,235
Intangible assets .....		652,287	652,287
Property and equipment .....		456,437	456,437
Other assets .....	2,281	1,803,439	1,805,720
<b>Total assets</b>	<b>273,820</b>	<b>45,970,650</b>	<b>46,244,470</b>

## Notes

<b>Liabilities</b>	Pre- acquisition	Acquired	Post- acquisition
Short positions in securities .....		6,465,096	6,465,096
Short positions in securities used for hedging .....		981,332	981,332
Derivatives .....		127,076	127,076
Deposits .....		32,735,841	32,735,841
Current tax liabilities .....		20,128	20,128
Deferred tax liabilities .....		216	216
Other liabilities .....	255,000	6,346,462	6,601,462
<b>Total liabilities</b>	<b>255,000</b>	<b>46,676,151</b>	<b>46,931,151</b>
<b>Net liabilities acquired</b>			<b>705,501</b>

## c. Goodwill

Goodwill was recognized as a result of the acquisition as follows:

Net liabilities acquired .....	705,501
Less loan to seller .....	(469,804)
<b>Goodwill</b>	<b>235,698</b>

The goodwill is attributable mainly to the skills and technical talent of the work force of the commercial bank operations. None of the goodwill recognised is expected to be deductible for income tax purposes.

## d. Transactions separate from the acquisition

The Bank incurred minor acquisition-related expenses relating to external legal fees and due diligence costs. These expenses have been included in administrative expenses in the Bank's consolidated statement of comprehensive income.

## Notes

### 48. Acquisition of ALFA verðbréf hf.

Through a contract dated 8 November 2011, the Bank acquired all outstanding shares in ALFA verðbréf hf. ALFA verðbréf hf. is a securities firm operating under a licence from the Icelandic Financial Supervisory Authority (FME). It provides financial advisory services, primarily to institutional investors, and has worked with Credit Suisse since 2004.

#### a. Consideration transferred

The Bank acquired all outstanding shares in ALFA verðbréf hf., with a nominal amount of ISK 23 million. The purchase price will be paid in full with a combination of cash and shares in the Bank.

#### b. Identifiable assets acquired and liabilities assumed

The acquisition had the following effect on the Bank's Statement of Financial Position:

<b>Assets</b>	<b>Acquired</b>
Cash and cash equivalents .....	16,197
Property and equipment .....	7,079
Other assets .....	17,717
<b>Total assets</b>	<b>40,994</b>
<b>Liabilities</b>	<b>Acquired</b>
Current tax liabilities .....	4,174
Other liabilities .....	2,566
<b>Total liabilities</b>	<b>6,740</b>
<b>Net assets acquired</b>	<b>34,254</b>

#### c. Goodwill

A goodwill of ISK 104 million was recognized as a result of the acquisition. The goodwill is attributable mainly to the business relationships acquired and is not expected to be deductible for tax purposes. Purchase price allocation has not been finalised and is on a provisional basis.

#### d. Transactions separate from the acquisition

The Bank incurred minor acquisition-related expenses relating to external legal fees and due diligence costs. These expenses have been included in administrative expenses in the Bank's consolidated statement of comprehensive income.

## Notes

### 49. Operating Segments

Financial information used by management in 2011 in deciding how to allocate resources and assess performance is that of the business as a whole. The Bank is therefore viewed as a single reportable segment.

### 50. Geographical information

	Net operating income	Total assets
<b>2011</b>		
Iceland .....	1,647,229	50,508,489
Lithuania .....	58,132	882,979
Other regions and eliminations .....	124,618	(1,282,372)
<b>Total</b>	<b>1,829,979</b>	<b>50,109,096</b>

	Net operating income	Total assets
<b>2010</b>		
Iceland .....	37,063	274,153
<b>Total</b>	<b>37,063</b>	<b>274,153</b>

### 51. Net interest income (expense)

Interest income is specified as follows:

	2011	2010
Cash and cash equivalents .....	419,537	0
Derivatives .....	221,475	0
Loans to customers .....	448,913	0
Other interest income .....	351,018	0
<b>Total interest income</b>	<b>1,440,943</b>	<b>0</b>

Interest expense is specified as follows:

	2011	2010
Deposits .....	956,155	0
Borrowings .....	4,431	0
Other interest expense .....	21,632	253
<b>Total interest expense</b>	<b>982,218</b>	<b>253</b>

<b>Net interest income (expense)</b>	<b>458,725</b>	<b>(253)</b>
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## Notes

### 52. Fee and commission income

Fee and commission income is specified as follows:

	2011	2010
Securities brokerage .....	101,362	0
Swap contracts on securities .....	114,105	0
Retail banking .....	131,714	0
Asset management .....	357,239	0
Loans .....	14,001	0
Advisory .....	38,229	0
Other .....	90,401	0
<b>Total</b>	<b>847,051</b>	<b>0</b>

### 53. Net financial income (loss)

Net financial income (loss) is specified as follows:

	2011	2010
Gain on shares and other variable income securities .....	99,301	0
Gain on fixed income securities .....	318,347	0
Dividend income .....	1,926	0
Foreign currency exchange difference .....	101,081	(71)
Fair value adjustments .....	(27,942)	0
<b>Net financial income (loss)</b>	<b>492,714</b>	<b>(71)</b>

### 54. Breakdown of foreign currency exchange difference

Foreign currency exchange difference is specified as follows:

	2011	2010
Loss on financial instruments at fair value through profit and loss .....	(27,628)	0
Gain (loss) on other financial instruments .....	128,709	(71)
<b>Total</b>	<b>101,081</b>	<b>(71)</b>
Change in ISK trade index during the year .....	+4.4%	-10.6%

Note 39 provides information about the development of foreign exchange rates against the Icelandic krona.

### 55. Administrative expenses

Administrative expenses are specified as follows:

	2011	2010
Salaries and related expenses .....	989,124	0
Other operating expenses .....	1,044,656	2,128
Depreciation and amortization .....	93,210	0
<b>Total administrative expenses</b>	<b>2,126,991</b>	<b>2,128</b>

## Notes

### 56. Salaries and related expenses

Salaries and related expenses are specified as follows:	2011	2010
Salaries .....	800,123	0
Pension fund contributions .....	94,058	0
Other salary related expenses .....	94,944	0
<b>Total salaries and related expenses</b>	<b>989,124</b>	<b>0</b>
Average number of employees during the year .....	116	0
Total number of employees at year-end .....	105	0

### 57. Employment terms for the board of directors and the CEO

Salaries paid to the board of directors and the CEO for their work for companies within the Bank, and their ownership in the Bank are specified as follows:

	Salaries		Ownership	
	2011	2010	31.12.2011	31.12.2010
Sigurður Atli Jónsson, CEO .....	11,582	0	25,000	0
Þorsteinn Pálsson, chairman of the board .....	4,500	0	0	0
Skúli Mogensen, deputy chairman of the board .....	2,250	0	960,600	0
Hanna Katrín Friðriksson, board member .....	2,610	0	0	0
Mario Espinosa, board member .....	2,250	0	0	0
Vilmundur Jósefsson board member .....	2,490	0	20,000	0
Baldur Oddur Baldursson, alternate board member .....	550	0	0	0
Gunnar Karl Guðmundsson, former CEO .....	28,787	0	0	0
<b>Total</b>	<b>55,019</b>	<b>0</b>	<b>1,005,600</b>	<b>0</b>

Neither the board of directors nor the CEO held any put or call options on the Bank's shares at year end. The CEO was a shareholder in ALFA verðbréf hf., a company acquired by the bank during the year, and as such is due to receive additional shares in the bank at a later date if conditions of the share purchase agreement are met. The acquisition is further discussed in note 48.

The Bank had no employees and paid no fees to board members in 2010.

### 58. Auditor's fees

Remuneration to the Bank's auditors is specified as follows:

	2011	2010
Audit of annual accounts .....	18,569	0
Review of interim accounts .....	4,467	0
Other services .....	2,380	0
<b>Total auditor's fees</b>	<b>25,416</b>	<b>0</b>
Thereof to the auditors of the parent company .....	19,964	0

### 59. Income tax

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

	2011	2010
Current tax income .....	32,704	0
Deferred tax income .....	82,898	0

## Notes

### Reconciliation of effective tax rate:

	2011		2010	
(Loss) profit before income tax .....		(599,151)		34,935
Income tax using the domestic corporation tax rate .....	20.0%	119,830	18.0%	(6,288)
Non-deductible expenses .....	(6.6%)	(39,268)	0.0%	0
Recognition of previously unrecognised tax losses .....	4.0%	23,906	(18.0%)	6,288
Other changes .....	1.9%	11,134	0.0%	0
Effective income tax	19.3%	115,602	0.0%	0

### 60. Special tax on financial institutions

According to act no. 155/2010 on Special Tax on Financial Institutions, certain types of financial institutions, including banks, must pay annually a tax based on the carrying amount of their liabilities as determined for tax purposes. The tax rate is set at 0.041%. This tax is not a deductible expense for income tax purposes. A temporary amendment to the act passed in 2011 increases the tax rate by 0.0875% for taxes payable in 2012 and 2013.

### 61. Quarterly statements (unaudited)

	Q1	Q2	Q3	Q4	2011
Net interest income .....	0	(45,154)	180,927	322,952	458,725
Net fee income .....	0	72,205	141,001	562,841	776,047
Net financial income .....	0	191,789	46,037	254,888	492,714
Share in associates .....	0	(16,354)	3,679	78,803	66,128
Other income .....	0	12,878	6,754	16,733	36,365
Net operating income	0	215,364	378,398	1,236,217	1,829,979
Administrative expenses .....	(330)	(737,436)	(523,496)	(865,729)	(2,126,991)
Impairment losses .....	0	(158,517)	(20,983)	(64,710)	(244,210)
Pre-tax profit (loss)	(330)	(680,589)	(166,081)	305,779	(541,221)

### 62. Cash and cash equivalents

Cash and cash equivalents are specified as follows:	31.12.2011	31.12.2010
Cash .....	123,762	0
Balances with banks .....	4,661,380	0
Central Bank depository certificates .....	6,760,002	0
Total cash and cash equivalents	11,545,143	0

### 63. Fixed income securities

Fixed income securities are specified as follows:	31.12.2011	31.12.2010
Government bonds .....	13,136,745	0
Other listed Icelandic bonds .....	338,975	0
Unlisted Icelandic bonds .....	203,144	0
Total fixed income securities	13,678,864	0

## Notes

### 64. Shares and other variable income securities

Shares and other variable income securities are specified as follows:	31.12.2011	31.12.2010
Listed Icelandic shares .....	86,686	0
Listed foreign shares .....	252	0
Listed foreign unit shares .....	152	0
Unlisted Icelandic unit shares .....	739,920	0
Unlisted foreign unit shares .....	66,267	0
Unlisted Icelandic shares .....	159,085	100,585
Unlisted foreign shares .....	16,169	0
<b>Total shares and other variable income securities</b>	<b>1,068,531</b>	<b>100,585</b>

### 65. Securities used for hedging

Securities used for hedging are specified as follows:	31.12.2011	31.12.2010
Government bonds .....	6,813,795	0
Listed Icelandic shares .....	615,485	0
Listed foreign shares .....	111,633	0
Other listed Icelandic bonds .....	153,924	0
<b>Total securities used for hedging</b>	<b>7,694,837</b>	<b>0</b>

### 66. Loans to customers

Loans to customers are specified as follows:	31.12.2011	31.12.2010
Loans to customers, gross amount .....	13,502,700	0
Provisions for credit losses .....	(208,397)	0
<b>Net loans to customers</b>	<b>13,294,303</b>	<b>0</b>

### 67. Allowance for impairment losses

Change in allowance for impairment losses is specified as follows:	Specific	Collective	Total
Balance as at 1 January 2011 .....	0	0	0
Charge to the income statement during the year .....	188,391	55,819	244,210
Final write-offs .....	(752)	0	(752)
Translation difference .....	(9)	0	(9)
<b>Balance as at 31 December 2011</b>	<b>187,629</b>	<b>55,819</b>	<b>243,448</b>

The impairment allowance is subtracted from the following items in the statement of financial position:

	31.12.2011	31.12.2010
Loans to customers .....	208,397	0
Other assets .....	35,051	0
<b>Total allowance at year-end</b>	<b>243,448</b>	<b>0</b>

## Notes

### 68. Intangible assets

Intangible assets are specified as follows:	Software	Goodwill	Other	Total
Book value as at 1 January 2011 .....	0	0	0	0
Additions .....	237,362	599,930	356,150	1,193,443
Impairment .....	(27,302)	0	0	(27,302)
Amortization .....	(28,592)	0	(13,811)	(42,403)
Translation difference .....	120	0	0	120
<b>Book value as at 31 December 2011</b>	<b>181,588</b>	<b>599,930</b>	<b>342,339</b>	<b>1,123,857</b>

The goodwill identified is the result of acquisitions of operations and assets from EA fjárfestingarfélag hf., the acquisition of ALFA verðbréf hf. and an acquisition of a 40% share in Júpíter rekstrarfélag hf. These acquisitions are further discussed in notes 47, 48 and 70.

### 69. Property and equipment

Property and equipment is specified as follows:	Real estate	Office equipment and fixtures	Total
Book value as at 1 January 2011 .....	0	0	0
Additions .....	348,441	160,134	508,575
Disposals .....	(129,375)	(9,030)	(138,405)
Impairment .....	0	(408)	(408)
Depreciation .....	(19,833)	(21,727)	(41,559)
Translation difference .....	320	77	397
<b>Book value as at 31 December 2011</b>	<b>199,553</b>	<b>129,047</b>	<b>328,599</b>

  

Specification of real estate:	Official value	Insurance value	Book value
Office building in Skipholt 50d, Reykjavík, Iceland .....	79,990	146,200	108,449
Office buildings in Vilnius, Lithuania .....	-	-	91,104
<b>Total</b>			<b>199,553</b>

### 70. Group entities

The Bank holds 8 subsidiaries, all of which are included in the consolidated financial statements. The direct subsidiaries included in the consolidated financial statements are specified as follows:

Subsidiaries	Domicile	Share 31.12.2011	Share 31.12.2010
ALFA verðbréf hf. ....	Iceland	100%	0%
Axia Asset Management UAB .....	Lithuania	100%	0%
Heildun UAB .....	Lithuania	100%	0%
Horn Florida Ltd. ....	UK	100%	0%
Júpíter rekstrarfélag hf. ....	Iceland	100%	0%
KFP ehf. ....	Iceland	100%	0%
M-Investments ehf. ....	Iceland	100%	0%
MP Pension Funds Baltic UAB .....	Lithuania	100%	0%

## Notes

On 1 April 2011 the Bank acquired the Icelandic and Lithuanian assets and operations of EA fjárfestingarfélag hf. Included in the assets acquired were shares in 8 subsidiaries but prior to that the Bank had no subsidiaries. The acquisition is further discussed in note 47.

Included in the acquisition from EA fjárfestingarfélag hf. was a 60% share in Júpíter rekstrarfélag hf. (Júpíter), which became a subsidiary of the Bank. On 1 July 2011 a call option on 26% of the total shares in Júpíter, granted to other shareholders of Júpíter, became active and the company was reclassified as an associated company. On 7 December 2011 the Bank acquired a further 40% share in Júpíter and the call option was revoked. As a result the company was reclassified as a subsidiary.

Varp Invest Ltd., a subsidiary acquired from EA fjárfestingarfélag hf., ceased operations and its assets were liquidated. The financial effects of the disposal were immaterial.

On 8 November 2011 the Bank acquired all outstanding shares in ALFA verðbréf hf., a company providing financial advisory services to institutional investors. The acquisition is further discussed in note 48.

### 71. Investment in associates

a. Changes in investments in associates are specified as follows:

	31.12.2011	31.12.2010
Balance at the beginning of the year .....	170,955	0
Acquisition of shares in associates .....	201,683	165,000
Share in results of associates .....	66,128	(29)
Reclassification .....	(38,409)	5,984
Foreign exchange translation difference .....	4,915	0
<b>Balance at year-end</b>	<b>405,272</b>	<b>170,955</b>

On 1 April 2011 the Bank acquired the Icelandic and Lithuanian assets and operations of EA fjárfestingarfélag hf. Included in the assets acquired were shares in 2 associates but prior to that the Bank's sole associate was Teris. The acquisition is further discussed in notes 47.

Júpíter rekstrarfélag hf., which was a subsidiary of the bank at year-end, was reclassified as an associate during the period 1 July 2011 to 7 December 2011. See note 70 for further discussion.

b. Information about associated companies at year-end:

	Share	Assets	Liabilities	Results
	31.12.2011	31.12.2011	31.12.2011	2011
GAM Management hf. (according to unaudited accounts) .....	37%	281,071	63,070	112,238
Londonderry Associates LLC (according to unaudited accounts) .....	38%	183,692	0	0
Teris (according to unaudited accounts) .....	29%	921,521	365,200	(161,675)

  

	Share	Assets	Liabilities	Results
	31.12.2010	31.12.2010	31.12.2010	2010
Teris .....	24%	923,663	205,666	(130,758)

### 72. Other assets

	31.12.2011	31.12.2010
Other assets are specified as follows:		
Accounts receivable and prepayments .....	662,246	2,614
<b>Total other assets</b>	<b>662,246</b>	<b>2,614</b>

## Notes

### 73. Short positions in securities

Short positions in securities are specified as follows:	31.12.2011	31.12.2010
Government bonds .....	4,769,566	0
Listed Icelandic bonds .....	68,954	0
Listed foreign shares .....	443	0
<b>Total short positions in securities</b>	<b>4,838,963</b>	<b>0</b>

### 74. Short positions in securities used for hedging

Short positions in securities used for hedging are specified as follows:	31.12.2011	31.12.2010
Government bonds .....	1,274,229	0
<b>Total short positions in securities used for hedging</b>	<b>1,274,229</b>	<b>0</b>

### 75. Deposits

Deposits are specified as follows:	31.12.2011	31.12.2010
Demand deposits .....	27,799,381	0
Time deposits .....	6,794,702	0
<b>Total deposits</b>	<b>34,594,083</b>	<b>0</b>

### 76. Borrowings

Borrowings are specified as follows:	31.12.2011	31.12.2010
Money market deposits .....	2,049,678	0
Other borrowings .....	1,477	0
<b>Total borrowings</b>	<b>2,051,155</b>	<b>0</b>

### 77. Deferred tax asset/liabilities

Change in deferred tax during the year:	31.12.2011	31.12.2010
Balance at the beginning of the year .....	0	0
Calculated income tax for the year .....	115,602	0
Income tax payable on current year's profit .....	(32,704)	0
Income tax recognised in other comprehensive income and equity .....	21,694	0
Other changes .....	2,977	0
<b>Net at year-end</b>	<b>107,569</b>	<b>0</b>

The Bank's deferred tax assets (liabilities) are attributable to the following balance sheet items:

	31.12.2011	31.12.2010
Property and equipment .....	(3,056)	0
Intangible assets .....	709	0
Assets and liabilities denominated in foreign currencies .....	(5,710)	(5,148)
Other items .....	(5,250)	0
Tax losses .....	120,876	38,704
<b>Deferred tax before write-down</b> .....	<b>107,569</b>	<b>33,556</b>
<b>Write-down of deferred tax asset</b> .....	<b>0</b>	<b>(33,556)</b>
<b>Net at year-end</b>	<b>107,569</b>	<b>0</b>

## Notes

### 78. Other liabilities

Other liabilities are specified as follows:	31.12.2011	31.12.2010
Unsettled securities transactions .....	720,821	0
Accounts payable .....	410,745	0
Withholding taxes .....	405,635	0
Various liabilities .....	610,006	255,000
<b>Total other liabilities</b>	<b>2,147,207</b>	<b>255,000</b>

### 79. Related parties

Definition of related parties:

The Bank has a related party relationship with its associates as disclosed in note 4, large shareholders, board members, CEO and members of the executive committee (together referred to as management) and close family members of these parties.

Balances and transactions with related parties are as follows:	31.12.2011	31.12.2010
Loans to management .....	17,873	0
During the year:	2011	2010
Interest income from loans to management .....	954	0
Fees from related parties .....	22,791	0
Fees to related parties .....	157,073	0
Assets acquired from a shareholder .....	10,400	0

Prior to the acquisition of assets and operations from EA fjárfestingarfélag hf. the Bank did not have a business relationship with related parties. Interest and fee amounts shown do therefore not include revenues posted before 12 April 2011 but may include corrections and adjustments posted after 12 April 2011.

Teris, an associate of the Bank, is the largest provider of IT services to the Bank.

### 80. Share-based payments

No stock options were outstanding as at 31.12.2011 or 31.12.2010.

## Notes

### 81. Equity

#### a. Share capital

According to the Bank's Articles of Association, share capital amounted to ISK 5,554 million at year-end 2011 (ISK 104 million at year-end 2010). The nominal amount of treasury shares was ISK 4 million at year-end 2011 (ISK 4 million at year-end 2010).

#### b. Required capital

Equity at the end of the period was ISK 5,069 million, equivalent to 10.1% of total assets according to the statement of financial position. The capital adequacy ratio of the Bank, calculated in accordance with Article 84 of the Act on Financial Undertakings, is 19.2%. The minimum according to the Act is 8.0%. The ratio is calculated as follows:

	31.12.2011	31.12.2010
Capital requirements for:		
Credit risk .....	1,016,740	0
Market risk .....	270,827	0
Operational risk .....	271,890	22,300
<b>Total risk base</b>	<b>1,559,457</b>	<b>22,300</b>
Tier 1 capital:		
Recorded capital .....	5,068,954	19,153
Goodwill and intangibles .....	(942,269)	0
Shares in financial institutions .....	(176,528)	0
Subordinated fixed income securities .....	(99,615)	0
Deferred tax asset .....	(107,872)	0
<b>Total capital</b>	<b>3,742,670</b>	<b>19,153</b>
Surplus (required) capital .....	2,183,213	(3,147)
<b>Capital adequacy ratio</b>	<b>19.2%</b>	<b>6.9%</b>

#### c. Capital management

A capital plan is prepared on an annual basis and approved by the Board with the objective of maintaining both the optimal amount of capital and the mix between the different components of capital. The Bank's policy is to hold capital in a range of different forms and from diverse sources.

The principal forms of capital are included in the following balances in statement of financial position: share capital, share premium, other reserves, and retained earnings. Capital also includes the collective impairment allowances held in respect of loans and advances.

The Icelandic Financial Supervisory Authority (FME) supervises the Bank on a consolidated basis and, as such, receives information on the capital adequacy of, and sets capital requirements for, the Bank as a whole.

### 82. Off-balance sheet obligations

#### Rental obligations

The Bank has entered into long-term rental agreements for office premises in Ármúli 13a and Borgartún 26 in Reykjavík. The cost and duration of these agreements is as follows:

	Expiration date	Monthly payments
Ármúli 13a .....	1.1.2015	3,610
Borgartún 26 .....	1.5.2012	1,626

## Notes

### 83. **Supreme Court ruling no. 600/2011 on interest rate calculations on loans linked to foreign currencies**

In February 2012 the Supreme Court of Iceland passed ruling no. 600/2011 in a case involving a dispute about interest rate calculations on a loan the court had previously ruled was currency indexed and as such in violation of Icelandic law. The ruling will have no material effect on the financial statements of the Bank.

### 84. **Events after the reporting date**

The board of directors of the Bank has approved a proposal for the merger of ALFA verðbréf hf., one of the Bank's subsidiaries at year-end, with the bank. The proposal is pending the approval of regulatory authorities and is expected to come into effect during the first quarter of 2012.