

ARION BANK'S 3M 2017 FINANCIAL RESULTS

First quarter 2017 compared with first quarter 2016:

- Operating income ISK 12.5 billion (ISK 12.0 billion)
- Net earnings ISK 3.4 billion (ISK 2.9 billion)
- Earnings per share ISK 1.60 (ISK 1.24)
- Net interest margin (NIM) 2.8% (3.1%)
- Return on equity 6.3% (5.7%)
- Cost-to-income ratio 64.4% (60.2%)
- Tier 1 ratio 27.3% (26.2%)

Höskuldur H. Ólafsson, CEO :

Operations are stable and the Bank is financially robust, as indicated by a capital ratio of 28%. The Bank's investments last year had a positive impact on operations. This includes increased commission income after Arion Bank became the sole provider of financial services at Keflavik International Airport in May 2016. Income from insurance activities also grew and now represent a larger share of the Bank's revenue stream following the acquisition of the insurance company Vördur last year.

Arion Bank reported net earnings of ISK 3.4 billion for the first three months of 2017, compared with ISK 2.9 billion for the same period of 2016. Return on equity was 6.3%, compared with 5.7% for the first three months of 2016.

Total assets amounted to ISK 1,119.7 billion at the end of March, compared with ISK 1,036.0 billion at the end of 2016. Shareholders' equity totaled ISK 214.6 billion at the end of March 2017, compared with ISK 211.2 billion at the end of 2016. The Bank enjoys a strong financial position and the focus has been on maintaining good liquidity as the capital controls are lifted, a process which is now largely at an end.

The Bank's capital ratio at the end of March was 28.0%, compared with 27.1% at the end of 2016. Tier 1 Capital increased during the period to 27.3%, compared with 26.5% at the end of 2016.

Highlights of the income statement and key income related performance indicators:

<i>In ISK million</i>	Q1 2017	Q1 2016	Diff	Diff%
Net interest income	7,160	7,273	(113)	(2%)
Net commission income	3,330	3,218	112	3%
Other income	2,023	1,468	555	38%
Operating income	12,513	11,959	554	5%
Operating expenses	(8,056)	(7,198)	(858)	12%
Bank levy	(797)	(742)	(55)	7%
Net impairment	880	(503)	1,383	(275%)
Net earnings before taxes	4,540	3,516	1,024	29%
Income tax	(1,334)	(737)	(597)	81%
Net gain from disc. operations	147	104	43	41%
Net earnings	3,353	2,883	470	16%
KPI's:				
Return on equity (ROE)	6.3%	5.7%		
Earnings per share (ISK)	1.68	1.24		
Net interest margin (int. bearing assets)	2.8%	3.1%		
Cost-to-income ratio	64.4%	60.2%		



Highlights of the balance sheet and key performance indicators:

<i>In ISK million</i>	31.03.2017	31.12.2016	Diff	Diff%
Loans	966,940	880,172	86,768	10%
Other assets	152,708	155,852	(3,143)	(2%)
Liabilities	904,868	824,640	80,228	10%
Equity	214,607	211,212	3,395	2%
Loans to Deposits ratio	151.4%	172.9%		
RWA / Total assets	66.4%	72.7%		
Tier 1 ratio	27.3%	26.5%		

HÖSKULDUR H. ÓLAFSSON, CEO OF ARION BANK:

“Arion Bank’s financial results for the first quarter of 2017 are in line with expectations. Operations are stable and the Bank is financially robust, as indicated by a capital ratio of 28%. The Bank’s investments last year had a positive impact on operations. This includes increased commission income after Arion Bank became the sole provider of financial services at Keflavik International Airport in May 2016. Income from insurance activities also grew and now represent a larger share of the Bank’s revenue stream following the acquisition of the insurance company Vördur last year. The impact of this acquisition will become clearer as the companies further collaborate on selling insurance products. It is positive that salaries expenses at the Bank have only risen slightly between years despite these added operations.

In March a milestone was reached when new investors became shareholders in the Bank. This represented a new stage in the ongoing process of selling the Bank. It is likely that the Bank will eventually be listed on a stock market, after which ownership will be in the hands of Icelandic and international investors. No decision on listing the Bank has been taken yet but it is positive that we have got the ball rolling, as it was always clear that the ownership structure in place since 2010 was only a temporary arrangement.

In January Nýherji, one of Iceland's leading IT companies, took over the administration of the Bank’s IT systems. We see this as a great opportunity to strike up a partnership with a market leader in its field, and more than 20 Arion Bank employees subsequently transferred to Nýherji. We retain a team of around 80 IT professionals working in software development and technology management. We will continue to seek collaboration with others where we can share resources and improve efficiency all around.

Last year we introduced several new digital solutions which were well received by our customers. This included a credit assessment for mortgages which can be completed online in just a matter of minutes. At the beginning of the year we introduced a new digital mortgage application process which is far shorter and more straightforward than previous application processes. Our customers can now apply for a mortgage online, without visiting a branch if they so choose. In May four new digital solutions will be launched. These solutions are designed to respond to changing demand for our services. We aim to continue to make our services available online and on mobile phone so that customers can do their banking whenever it suits them.

Diversifying our funding has been one of our key focuses in recent years. In January the Bank tapped its bond issue from December 2016 for a further €200 million, bringing the total issue to €500 million. As before, part of the issue was used to pay down existing loans. It is pleasing to see that the Bank has had a positive response on the international credit markets. Bonds issued by Arion Bank have performed well on the secondary market, demonstrating the market's confidence in the Bank and its future prospects. In Iceland, the Bank continues to successfully issue commercial paper and covered bonds and this is an important component of the Bank’s funding.”



INCOME STATEMENT

<i>In ISK million</i>	Q1 2017	Q1 2016	Diff	Diff%
Net interest income	7,160	7,273	(113)	(2%)
Net commission income	3,330	3,218	112	3%
Net financial income	1,230	(300)	1,530	(510%)
Net insurance income	447	145	301	208%
Share of profit of associates	(34)	677	(711)	(105%)
Other operating income	380	946	(566)	(60%)
Operating income	12,513	11,959	553	5%
Salaries and related expense	(4,222)	(4,108)	(114)	3%
Other operating expenses	(3,834)	(3,091)	(743)	24%
Bank Levy	(797)	(742)	(55)	7%
Net change in valuation	880	(503)	1,383	(275%)
Net earnings before taxes	4,540	3,515	1,025	29%
Income tax	(1,334)	(737)	(597)	81%
Net earnings from continuing operation	3,206	2,778	428	15%
Net gain from disc. operations	147	104	43	41%
Net earnings	3,353	2,882	471	16%

Operating income amounted to ISK 12.5 billion for the first quarter of 2017, compared with ISK 12.0 billion for the same period in 2016. The main positive changes between years are in net financial income due to favorable market conditions and improvements in net insurance income due to the newly acquired subsidiary Vördur. There was a negative change in other income, mainly related to a profit from asset sales in the first quarter of 2016.

Net interest income decreased by 2% from the previous year. The net interest margin as a percentage of average interest-bearing assets was 2.8% during the first quarter of 2016, compared with 3.1% for the same period in 2016. The decrease in net interest income is mainly due to lower inflation compared with the same period last year and an increase in cash and cash balances at period end that affects the calculation.

Net commission income increased by 3% between years, primarily due to increased activity in retail banking.

Net financial income amounted to ISK 1,230 million, compared with a loss of ISK 300 million for the first quarter of 2016. Favorable market developments for listed bonds and shares is the main reason for changes between years but mark to market changes on hedging derivatives related to funding were unfavorable during the period.

Net insurance income amounted to ISK 447 million, compared with ISK 145 million for the first quarter of 2016. The increase is primarily due to the acquisition of the insurance company Vördur at the end of September 2016.

Share in the profit of associates was negative by ISK 34 million during the first quarter of 2017, compared with positive ISK 677 million for the same period in 2016. This change is mainly due to a profit from the sale of equity holdings in Bakkavor Group Ltd. during the first quarter of 2016.

Other operating income decreased by ISK 566 million from the previous year and amounted to ISK 380 million during the first quarter of 2017. A large part of the additional income in 2016 was due to profits from the sale of assets during the period.

Operating expenses amounted to ISK 8,056 million during the first quarter of 2017, compared with ISK 7,199 million for the same period of 2016. The Bank's cost-to-income ratio was 64.4%, compared with 60.2% in the first quarter of 2016. The reason for the increased ratio is a combination of higher expenses, partly related to the newly acquired subsidiary Vördur and the growth of international operations at the subsidiary Valitor, and minor changes in operating income.

Salaries and related expenses amounted to ISK 4,222 million during the period, an increase of 3% from the previous year. The increase is mainly due to the acquisition of Vördur and the increased number of employees at the subsidiary Valitor. The average salary per employee decreased by 2.2% from the same period in 2016, but at the same time the salary index in Iceland rose by 2.0%. Full-time equivalent positions at the end of the quarter totalled 1,204 at the Group, 41 more than at the end of the first quarter of 2016. The increase is largely a result of investments in new business opportunities in Iceland and abroad. Most significant in this respect is the



acquisition of the insurance company Vördur, the growth of Valitor internationally and the opening of a new branch at Keflavik International Airport.

Other operating expense amounted to ISK 3,834 million during the first quarter, or a 24% increase from the same period last year. The increase is partially related to the new subsidiary Vördur, increased activities in the international operations of Valitor and higher IT expense due to the outsourcing of the IT operation.

Net valuation change was positive by ISK 880 million during the first quarter of 2017 but was negative by ISK 503 million in the same period last year. The positive net impairment is mainly due to composition payments from corporate customers and prepayments of mortgage loans to individuals during the quarter.

Income tax amounted to ISK 1,334 million, compared with ISK 737 million for the first quarter in 2016. Income tax, as reported in the annual financial statements, comprises 20% income tax on earnings and a special 6% financial tax on the earnings of financial undertakings in excess of ISK 1 billion. The effective income tax rate was 29.4%, compared with 21.0% for the same period last year. The unusually high tax rate during the first quarter is due to how much income is from the parent company, which calculates additional 6% tax on income above 1 billion and thus the effective income tax rate is higher.

Earnings of operating segments

Arion Bank divides its operations into five profit centers plus ancillary units. The Bank's profit centers are Asset Management, Corporate Banking, Investment Banking, Retail Banking and Treasury.

All of the Bank's profit centers made a profit before income tax during the first quarter of 2017.

<i>1.1.-31.3.2017</i> <i>In ISK million</i>	Asset Management	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other div., headq. and subsidiaries	Total
Net interest income	146	1,656	69	3,974	1,096	219	7,160
Net commission income	838	176	333	996	(78)	1,065	3,330
Other income	48	176	(31)	55	(271)	2,046	2,023
Operating income	1,032	2,008	371	5,025	747	3,330	12,513
Operating expenses	(405)	(188)	(194)	(1,681)	(47)	(5,541)	(8,056)
Bank levy	0	0	0	0	0	(797)	(797)
Net impairment	0	819	14	20	55	(28)	880
Net earnings before taxes	627	2,639	191	3,364	755	(3,036)	4,540

<i>1.1.-31.3.2016</i> <i>In ISK million</i>	Asset Management	Corporate Banking	Investment Banking	Retail Banking	Treasury	Other div., headq. and subsidiaries	Total
Net interest income	157	1,585	832	4,028	642	29	7,273
Net commission income	949	256	324	721	(114)	1,083	3,219
Other income	12	10	704	31	0	710	1,467
Operating income	1,118	1,851	1,860	4,780	528	1,822	11,959
Operating expenses	(389)	(162)	(337)	(1,335)	(50)	(4,925)	(7,198)
Bank levy	0	0	0	0	0	(742)	(742)
Net impairment	0	194	1,324	(1,993)	0	(28)	(503)
Net earnings before taxes	729	1,883	2,847	1,452	478	(3,873)	3,516



Asset Management comprises Institutional Asset Management, Private Banking, Investment Services and Pension Fund Administration. Asset Management manages financial assets on behalf of its customers according to a pre-determined investment strategy. In addition, the division is the main distributor of funds managed by Stefmir hf. to individuals, companies and institutional investors as well as distributing funds managed by international fund management companies. Asset Management also administers pension funds. Stefmir hf. is an independently operating financial company owned by Arion Bank. Stefmir manages a broad range of mutual funds, investment funds and institutional investor funds.

<i>In ISK million</i>	Q1 2017	Q1 2016	Difference
Net interest income	146	157	(7.0%)
Net commission income	838	949	(11.7%)
Other income	48	12	300.0%
Operating income	1,032	1,118	(7.7%)
Operating expenses	(405)	(389)	4.1%
Net earnings before taxes	627	729	(14.0%)

The decrease in operating income from the first quarter of 2016 is mainly related to changes in the market environment. The operation is although stable and assets under management are developing well.

Corporate Banking provides comprehensive financial services and integrated solutions across the Bank's divisions to larger corporate clients in Iceland. Corporate Banking provides a full range of lending products, deposit accounts, payment solutions as well as value-added electronic corporate solutions to meet the needs of each customer.

<i>In ISK million</i>	Q1 2017	Q1 2016	Difference
Net interest income	1,656	1,585	4.5%
Net commission income	176	256	(31.3%)
Other income	176	10	1,660.0%
Operating income	2,008	1,851	8.5%
Operating expenses	(188)	(162)	16.0%
Net impairment	819	194	322.2%
Net earnings before taxes	2,639	1,883	40.1%

The net interest margin at Corporate Banking is similar to the same period in 2016 but the decrease in net fee and commission income is mainly related to less activity in new lending during the first quarter compared to the same period last year.

Investment Banking is divided into Corporate Finance, Capital Markets and Research. Corporate Finance arranges the buying and selling of companies and advises on other major financial decisions undertaken by companies and investors such as financial restructuring, IPO's and stock market listings. Capital Markets buys and sells securities and FX on behalf of Arion Bank's clients. Capital Markets manages securities issuance for clients and advises on hedges used in business operations, often in co-operation with Corporate Finance. Research is an independent research team covering the Icelandic economy and financial markets.

<i>In ISK million</i>	Q1 2017	Q1 2016	Difference
Net interest income	69	832	(91.7%)
Net commission income	333	324	2.8%
Other income	(31)	704	(104.4%)
Operating income	371	1,860	(80.1%)
Operating expenses	(194)	(337)	(42.4%)
Net impairment	14	1,324	(98.9%)
Net earnings before taxes	191	2,847	(93.3%)



Changes were made in Investment Banking in 2016, when a large part of the division's assets were transferred to other divisions, mainly to the CEO's office, which is a part of the headquarters in the segment reporting. Therefore changes in Net interest income and Other income are quite significant between years. Net fee and commission income, which is the main source of income for the segment, was stable compared with the same period in 2016.

Retail Banking provides a comprehensive range of services. This includes deposits and loans, savings, payment cards, pension savings, insurance, securities and funds. To maximize operational efficiency the branch network is divided into five clusters, with the smaller branches capitalizing on the strength of larger units within each cluster. Retail Banking's 24 branches all around Iceland have a total of more than 100,000 customers. Arion Bank Mortgages Institutional Investor Fund is a part of Arion Bank's retail operations.

<i>In ISK million</i>	Q1 2017	Q1 2016	Difference
Net interest income	3,974	4,028	(1.3%)
Net commission income	996	721	38.1%
Other income	55	31	77.4%
Operating income	5,025	4,780	5.1%
Operating expenses	(1,681)	(1,335)	25.9%
Net impairment	20	(1,993)	(101.0%)
Net earnings before taxes	3,364	1,452	131.7%

Operating income from the period increased by 5% between years and the greater focus on fee generating operation is resulting in higher income. The positive change in Net impairment is due to the one-off effect of the government payment on mortgages, which was finalized in early 2016.

Treasury is responsible for the Bank's liquidity, currency and interest rate management. Other functions of Treasury are funds' transfer pricing and hedging and pricing of financial products.

<i>In ISK million</i>	Q1 2017	Q1 2016	Difference
Net interest income	1,096	642	70.7%
Net commission income	(78)	(114)	(31.6%)
Other income	(271)	0	-
Operating income	747	528	41.5%
Operating expenses	(47)	(50)	(6.0%)
Net impairment	55	0	-
Net earnings before taxes	755	478	57.9%

Operating income from Treasury increased between years, mainly due to higher interest income from cash balances at Central Bank but there is a loss from Other income, mainly due to mark to market changes on derivatives which are used for hedging but are not in hedge accounting. Inflation is usually low during the first quarter and therefore the net interest income at Treasury is low during this period compared to other quarters.



BALANCE SHEET

Arion Bank's **total assets** increased by 8% from year end 2016. The main increase results from balances with the Central Bank and loans to customers but loans to credit institutions and financial assets decreased however.

<i>In ISK million</i>	31.03.2017	31.12.2016	Diff	Diff%
Cash & balances with CB	178,593	87,634	90,960	104%
Loans to credit institutions	68,149	80,116	(11,967)	(15%)
Loans to customers	720,198	712,422	7,776	1%
Financial assets	110,674	117,456	(6,782)	(6%)
Investment property	5,911	5,358	553	10%
Investments in associates	818	839	(21)	(2%)
Intangible assets	11,121	11,057	64	1%
Other assets	24,184	21,142	3,042	14%
Total assets	1,119,648	1,036,024	83,624	8%

Cash and cash balances with Central Bank amounted to ISK 178,593 million at the end of the first quarter, compared with ISK 87,634 million at the end of 2016. The increase is mainly due to new short-term deposits from institutional investors at the end of the quarter.

Loans to customers totaled ISK 720,198 million at the end of the first quarter of 2017, representing a 1% increase from year-end 2016. Loans to corporates increased by 1.7%, mainly in the real estate sector and wholesale and retail. Loans to individuals increased by less than 1% during the first quarter of 2017. The quality of loans to customers continues to improve. The ratio of problem loans decreased from 1.6% to 1.5% during the quarter. The Bank defines problem loans as the ratio of the book value of loans 90 days or more in default and loans for which special impairment is required to the Bank's total loans to customers. The proportion of impaired loans decreased from 3.2% at the end of 2016 to 2.4% at the end of the first quarter of 2017.

Financial assets amounted to ISK 110,674 million at the end of the first quarter, compared with ISK 117,456 million at the end of 2016. Financial assets decreased due to the sale of assets, including the sale of listed equities in Fasteignafélagið Reitir hf. and Síminn hf. Changes in financial assets are also partly related to liquidity management.

Liabilities increased from year end, which is primarily a result of short-term deposits and new borrowings. **Equity** increased as a result of the positive financial results in the first quarter of 2017.

<i>In ISK million</i>	31.03.2017	31.12.2016	Diff	Diff%
Due to credit institutions & CB	9,689	7,987	1,702	21%
Deposits from customers	475,641	412,064	63,577	15%
Financial liabilities at fair value	3,922	3,726	196	5%
Other liabilities	59,983	61,387	(1,404)	(2%)
Borrowings	355,633	339,476	16,157	5%
Shareholders equity	214,607	211,212	3,395	2%
Non-controlling interest	173	172	1	1%
Total liabilities and equity	1,119,648	1,036,024	83,623	8%

Deposits from customers amounted to ISK 475,641 million at the end of the first quarter 2017, compared with ISK 412,064 million at the end of 2016. The increase is mainly due to short-term deposits from institutional investors at quarter end and will not reflect the future deposit base.

Borrowings amounted to ISK 355,633 million at the end of the period. In January the Bank added to a 5-year €200 million bond issue from November, and the total issue now is €500 million. This issue was partially used in prepayment of a USD bond held by Kaupthing with the outstanding issue now down to \$100 million. The Bank took part in three international private placement issues amounting to ISK 5.1 billion in NOK and SEK during the first quarter. The Bank has also continued to issue covered bonds in the Icelandic market, a total of ISK 4.7 billion during the quarter.



Shareholders' equity amounted to ISK 214,607 million at the end of the first quarter 2017, compared with ISK 211,212 million at the end of 2016. The increase is explained by the financial results for the period, but no dividend payment has been decided. The Tier 1 ratio was 27.3% at the end of the first quarter, compared with 26.5% at the end of 2016. According to the FME's rules on calculating capital ratios, it is not permitted to take financial results into account unless they are endorsed by an auditor. The capital ratio according to the FME's rules was 26.9% at the end of March, compared with 26.5% at the end of 2016.

EVENTS AFTER 31 MARCH 2017

On 10 May Monica Caneman decided to step down from the Board of Directors of Arion Bank. Monica has been Chairman of the Board since 2010. Guðrún Johnsen, who has been Vice-Chairman of the Board during the same period, takes over the responsibilities of Chairman of the Board of Directors.

