



# Newsletter

Financial Institutions - First edition - March 2011

## Financial results for 2010

Arion Bank reported net earnings of ISK 12.6 billion in 2010, compared with ISK 12.9 billion in 2009. Return on equity was 13.4%.

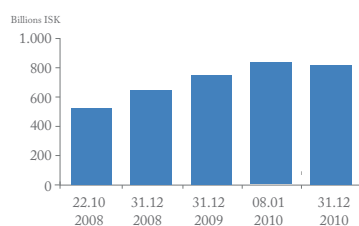
The Bank's core operations strengthened in 2010. Net interest margin was 2.8% in 2010, compared with 1.9% in 2009. The increase is due to a rise in interest-bearing assets when the Bank was recapitalized in January and also because of falling interest rates.

Commission income increased between years. The addition of the payment services company Valitor – Visa Iceland to the Arion Bank group in the fourth quarter made a positive impact in this respect.

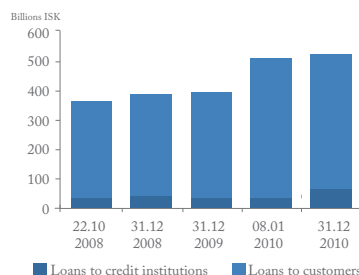
Income statement - consolidated		
Million ISK	2010	2009
Net interest income	19,785	12,188
Net change in valuation on loans and receivables	1,878	-296
Net interest income less value on loans and receivables	21,663	11,892
Net commission income	6,866	5,862
Net financial income	1,361	10,353
Other operating income	5,733	3,758
<b>Operating income</b>	<b>35,623</b>	<b>31,865</b>
Salaries and related cost	-9,272	-8,073
Other operating expenses	-9,020	-7,273
<b>Net earnings before taxes</b>	<b>17,331</b>	<b>16,519</b>
Income taxes	-3,481	-2,536
Bank levies	-290	0
Net gain (loss) from discontinued oper. net of tax	-1,003	-1,080
<b>Net earnings</b>	<b>12,557</b>	<b>12,871</b>

During the year the capital ratio increased in total by 5.3 percentage points to 19% at the end of 2010, well above the FME's minimum requirement of 16%.

Total assets



Total loans



On 8 January Kaupthing acquired an 87% share in Arion Bank. Assets increased by ISK 80.2 billion and the capital ratio rose by 2.7% percentage points from 13.7% to 16.4%. During the year the capital ratio increased in total by 5.3 percentage points to 19% at the end of 2010, well above the FME's minimum requirement of 16%. The Bank's liquidity ratio was 24.8% at the end of the year, surpassing the 20% requirement of the FME.

Total assets amounted to ISK 812.6 billion at the end of 2010, compared with ISK 757.3 billion at the end of 2009. Loans to customers totalled ISK 451.2 billion at the end of 2010, compared with ISK 357.7 billion at the end of 2009. This increase is mainly related to new loans acquired by the Bank following the change in ownership on 8 January 2010.

For further information on the accounts please visit our website.

## Good progress in corporate *recovery*

From the outset Arion Bank has prioritized corporate recovery projects very clearly, starting with cases from Corporate Banking and larger projects from Retail Banking, i.e. companies that had debts to the Bank in excess of ISK 100 million. This important work has progressed well and is close to completion.

In the autumn of 2010 the focus shifted from larger corporations on to SMEs, with a view to reaching all the companies which had not yet been in contact with the Bank.

The methods devised and implemented by Arion Bank in the debt recovery process were to a large extent adopted into an agreement on the debt recovery of small and medium-sized companies which the main business sector interest groups, financial companies, the Ministry of Economic Affairs and the Ministry of Finance signed in December 2010.

Almost 1,000 corporate customers of Arion Bank were estimated to require financial restructuring, and 840 of them have already entered the recovery process. Agreements have been reached in the case of more than 640 companies, of which 370 have fully completed the recovery process. Corporate recovery cases are expected to be brought to a conclusion by the end of 2011.

The progress made in corporate recovery is very important, not only for the individuals and businesses involved but also for Arion Bank. In the last two years an enormous amount of effort has gone into analysing the Bank's loan portfolio. The result is a deep understanding of the loan portfolio and the work that is needed to normalize it. As we get closer to finalizing the recovery of our customers we gain a clearer view of the quality of the Bank's key assets.

## *Increased* executive authority in the branch network

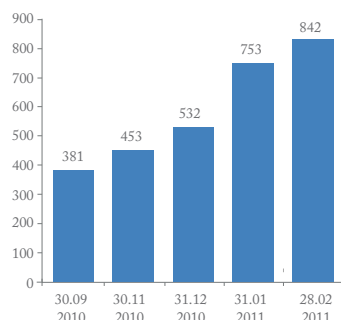
A core aspect in Arion Bank's strategy is the focus on relationship banking; to strengthen the business relationship we have with our customers. We feel strongly about the importance of moving decision-making closer to the customers for the successful implementation of the strategy. With this in mind Arion Bank is evolving a branch network with fewer but larger and stronger branches with greater executive authority. In the last two years the Bank has closed or merged 15 branches and currently operates 24 branches.

To maximize operational efficiency the branch network is divided into seven clusters, each with its own business manager. Smaller branches capitalize on the strength of larger units within each cluster. An important milestone in the new branch structure will be reached with the merger of three existing branches in the Reykjavík area into one on 23 March 2011. The new branch will be a symbol of the Bank's new strategy of extensive financial services and increased executive authority in the branch network.

## The continuing saga of *FX loans*

In our last issue we briefly discussed a bill passed by the Icelandic Parliament in 2010 which effectively turned FX mortgage loans to individuals into ISK denominated loans bearing Icelandic interest rates as published by the Central Bank of Iceland. The banks had until 26 February 2011 to recalculate the FX loans into ISK loans as stipulated in the bill.

Companies that have entered the recovery process



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### ***Continued uncertainty in regards to corporate FX loans***

Neither the bill passed by the Parliament nor the Supreme Court rulings from 2010 touched up on the issue of legality of FX loans to corporations.

Recent Supreme Court rulings and lower court rulings have found that certain SME FX loans are illegal. These rulings place some uncertainty on the legality of SME FX loans in general.

In this respect it is important to point out that in the summer of 2010 the legality of Arion Bank's FX loans to businesses was assessed by a team of experts at the Bank and the FME. They concluded that the legality of some foreign currency loans to companies was beyond doubt but that some loan agreements used in retail banking were more vulnerable. In light of the recent Supreme Court rulings on similar loans, there is continued doubt over the legality of these loans, depending on the specifics of the loan agreement and the execution of the loan.

### ***Capital ratio above 16%***

It is clear that if all the Bank's corporate FX loans whose legal status is uncertain were deemed illegal, the financial damage suffered by the Bank would be substantial. Nevertheless, after taking into account the reduced risk from these loans and the reduction in foreign currency imbalance, the capital ratio of Arion Bank will remain above the stringent 16% requirement of the FME.

## ***Sale of businesses acquired in relation to problem debt***

Arion Bank has over the last two years taken over the shareholdings of some of its debtors due to their inability to continue to service their debt to the Bank. This is done with the sole purpose of protecting and maximizing the Bank's interests. Selling shareholdings in acquired businesses which are unrelated to the Bank's core business, after taking the businesses through necessary financial restructuring, is a priority for the Bank.

In 2010 the preparations for the sale of a strategic share in the retail consortium Hagar began. The process was concluded in February 2011 with the sale of a 34% stake. The next stage is to list the company on the Icelandic stock market.

The car dealership Hekla was advertized for sale towards the end of 2010 and the sales process was completed in early 2011 with the sale of 100% of Hekla's share capital.

## ***Open meeting on the Icesave agreement***

The President of Iceland decided to refer the so-called Icesave bill to a referendum which will take place on 9 April. The bill, supported by 44 of Iceland's 63 members of parliament, authorizes the Minister of Finance to ratify agreements between the governments of Iceland, the United Kingdom and the Netherlands in relation to the Icesave savings accounts of Landsbanki Íslands.

To discuss the economic effects of the potential outcomes of the referendum, Arion Bank held an open meeting at its headquarters with experts from Iceland and abroad invited to

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speak on the topic.

## Important *Milestones* in 2010



At the beginning of the year Arion Bank's ownership structure changed when Kaupthing's subsidiary Kaupskil acquired an 87% share in the Bank, with the Icelandic State Banking Agency holding the other 13%. Following the change in ownership the Bank was recapitalized.



A new Board of Directors was elected and it took up its duties on 18 March. The Chairwoman is Monica Caneman. Höskuldur H. Ólafsson took over as Chief Executive Officer on 1 June.



The Bank implemented a new strategy during the year and subsequently made changes to the organizational structure to better reflect the emphasis on relationship banking which is at the core of the Bank's new strategy. Several new people joined the Bank's management team.



Systematic efforts were made to streamline operations, including the branch network. The Bank currently has 24 branches and reduced by 15 from 2008.



One of the Bank's main activities during 2010 was the action taken to resolve corporate and household debt difficulties. Arion Bank has achieved considerable results in this area. More than 14,000 personal customers have taken advantage of the solutions on offer. Arion Bank opened a special advisory service at the beginning of November which has received positive response. To date around 840 companies have entered the recovery process and a solution has been reached in 640 of these cases.

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## Economic update

Each month the Research department at Arion Bank sends out an economic update with the latest economic developments in Iceland. To subscribe to mailing list or to read the latest economic updates please visit <http://www.arionbanki.is/?PageID=5394>

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