



# Newsletter

Financial Institutions - Third edition - September 2010

## Results for the first six months of 2010

Net earnings of ISK 7.9 billion for the first half of 2010

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Arion Bank reported net earnings of ISK 7.9 billion for the first half of 2010 according to the reviewed interim financial statements. Annualized return on equity was 17.7% for the first half of 2010. The capital ratio at the end of June was 16.4%.

Kaupskil's acquisition of 87% of Arion Bank on 8 January 2010 reinforced the Bank's capital base with an injection of new capital. At the same time the Icelandic government provided a subordinated loan of ISK 29 billion. The Bank's capital ratio on 30 June 2010 was 16.4%, which is above the 16% required by the Icelandic Financial Supervisory Authority. Arion Bank meets all the capital and liquidity requirements stipulated by the regulatory authorities.

### Income statement

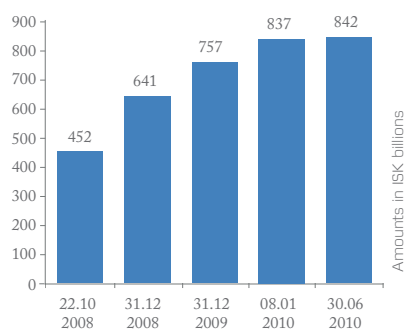
#### Income statement - consolidated

Million ISK	1H 2010	FY 2009
Net interest income	10,297	12,146
Change in valuation on loans and receivables	339	-296
Net interest income less val.on loans and receiv.	10,636	11,850
Net commission income	2,852	5,862
Net financial income	1,407	10,353
Other operating income	12,853	21,570
<b>Operating income</b>	<b>27,748</b>	<b>49,635</b>
Salaries and related cost	-6,208	-10,413
Other operating expenses	-12,102	-23,815
<b>Net earnings before taxes</b>	<b>9,438</b>	<b>15,407</b>
Income taxes	-1,501	-2,536
<b>Net earnings</b>	<b>7,937</b>	<b>12,871</b>

### Assets

Total assets amounted to ISK 842.3 billion on 30 June 2010, compared with ISK 757.3 billion at the end of 2009. This change can largely be attributed to the acquisition by Kaupskil of 87% of Arion Bank on 8 January 2010, which increased the Bank's total assets by ISK 80.2 billion to ISK 837.6 billion. The Bank's loan portfolio increased by ISK 112.8 billion while its bondholdings decreased by ISK 32.6 billion after the government was repaid 87% of its shareholding in the Bank.

Arion Bank's solid performance during the first six months of 2010 clearly demonstrates its increasing financial strength.



## Less uncertainty over FX loans

Recent rulings by the Supreme Court in Iceland on FX automobile loans were the source of great uncertainty on the Icelandic financial market this summer. Below we briefly discuss the background to these rulings and what they entail for Arion Bank.

### *The background*

For almost 10 years Icelandic financial institutions offered loans in foreign currencies to the general public regardless of whether the borrower had income in foreign currencies or not. This was in part a reaction to the market's demand for alternatives to inflation-indexed ISK denominated loans during years of high inflation and high interest rates.

During this period Icelandic law dictated that lending in foreign currencies is legal but lending in ISK and linking the principal and repayments on the loan to foreign currencies is illegal. This distinction is at the core of the uncertainty surrounding the foreign currency loans, i.e. which loan agreements are in fact FX denominated loans and which are currency-linked ISK loans.

The financial institutions that offered their customers FX loans assumed that these loans complied with Icelandic law. The Icelandic Financial Supervisory Authority (FME) and the Central Bank of Iceland (CBI) never made any attempts to halt this development.

### *The Supreme Court rulings*

During the summer the Supreme Court issued three rulings on different FX automobile loans. Before, the District Court had ruled that one of two FX automobile loans was legal but the other not. In the first two rulings of the Supreme Court the conclusion was that the loan agreement in each case was in fact an ISK loan linked to the rate of certain foreign currencies but not an actual FX denominated loan. Therefore, the currency-linked loan was deemed illegal.

In mid September the Supreme Court issued its third ruling. This time the crux of the issue before the court was the interest rate on a loan which earlier had been deemed by the Court to be denominated in ISK and not in a foreign currency; the question was whether it (and other loans like it) should bear the low interest rate as stated in the loan agreement, interest that is in line with foreign currencies, or whether it should, as the loan was in fact a loan denominated in ISK, bear the much higher Icelandic interest rates. The Supreme Court ruled that the loan should bear the higher interest rates, i.e. interest rates equal to interest rates of non-indexed loans issued by the CBI.

Within different financial institutions, and between institutions, we find multiple versions of FX loans agreements to individuals that could potentially be deemed illegal by the courts. It could take years to determine which agreements are in fact legal and which are not. To reduce the uncertainty and resolve the situation more quickly the Minister of Economic and Business Affairs announced following the ruling in mid September that he would propose a bill in the Parliament which would make all FX loans to individuals, including mortgages, ISK denominated loans in compliance with the Supreme Court's rulings.

It should be noted that there still is uncertainty regarding FX loans to corporations. In all likelihood these will have to be resolved on a case by case basis. However, it is safe to assume that a reasonable proportion of corporate loans comply with Icelandic law as they are loans to companies which generate income in foreign currencies and have presumably been executed in a legal manner.

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### *What does all this mean for Arion Bank?*

Firstly, it should be noted that the bill of law has yet to be proposed by the Minister. Furthermore, the bill could change while being discussed by the Parliament, or might not even be passed at all.

Arion Bank has no automobile loans on its Balance Sheet, but the Bank has FX mortgages to individuals, and FX loans to corporations.

It should be made clear that if the Minister's bill becomes law and all FX denominated mortgage loans to individuals are deemed to be loans in ISK, it would have a negative effect on the Bank's capital base, but only to a limited extent.

In cooperation with the FME Arion Bank has assessed the Supreme Court's rulings and their possible effects on the Bank's capital base and financial position. Arion Bank believes that even if the proposed bill is passed into law it will have a limited effect on the Bank's financial position; the Bank will continue to meet the requirements of the FME of a 16% capital ratio and 20% liquidity ratio.

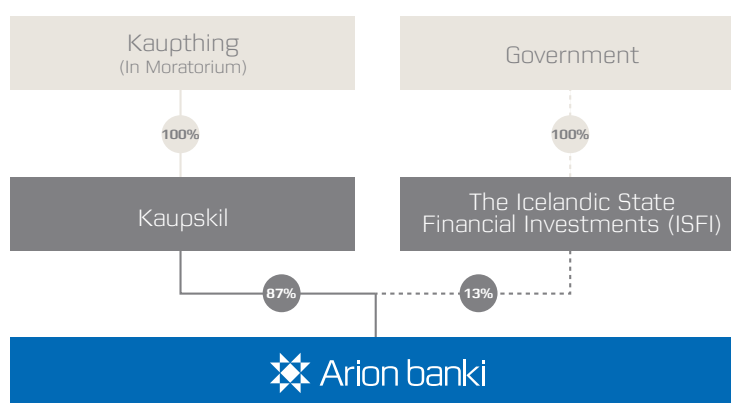
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## Ownership structure of Arion Bank

As discussed in the 2nd edition of our Newsletter the Resolution Committee of Kaupthing, on behalf of the creditors of Kaupthing, took an 87% ownership stake in Arion Bank on 8 January 2010. The remaining 13% stake is owned by the Icelandic government via the Ministry of Finance. Here we will briefly discuss the ownership structure of Arion Bank.

Neither the Icelandic state nor Kaupthing hold their shares in Arion Bank directly. Kaupthing holds its share through its subsidiary Kaupskil and the Icelandic state through an independent holding company, The Icelandic State Financial Investments (ISFI). The ISFI holds the government's stake in all three of the largest Icelandic banks.

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The majority of the board members in the ISFI and Kaupskil are independent, i.e. independent of Kaupthing, the government and Arion Bank. This ownership structure, where neither the government nor the Resolution Committee of Kaupthing hold their shares in Arion Bank directly but through independent intermediaries, was a requirement of the FME.

The board of Kaupskil has three members elected by Kaupthing. Two of them are independent and one is a member of the Resolution Committee of Kaupthing.

Kaupskil appointed five board members of Arion Bank and the ISFI appointed one. For information on the board members of Arion Bank please visit our website: <http://www.arionbanki.is/?PageID=5492>

## Organisational changes at Arion Bank

Some organisational changes were made at Arion Bank during the summer.

Treasury has been separated from Capital Markets and incorporated into the Finance division. Stefán Pétursson has been appointed Chief Financial Officer (CFO). In recent years Mr. Pétursson has served as the CFO of Landsvirkjun. Eggert Teitsson, who has been Arion Bank's CFO since its establishment, will become Deputy CFO.

Changes have also been made to the Bank's communications team. Ida Brá Benediktsdóttir, who has held the position of Head of Financial Institutions, will head the communications team in the CEO's Office and will be responsible for public and internal relations, as well as relations with financial institutions and investors.

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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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