CONSOLIDATED FINANCIAL STATEMENTS

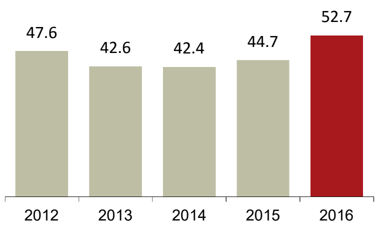
2016

Contents

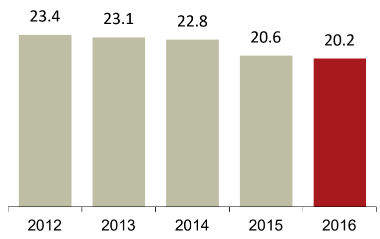
Financial Highlights 2016

ISK billion

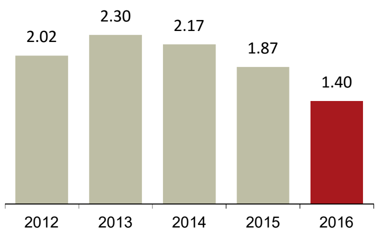
Operating income



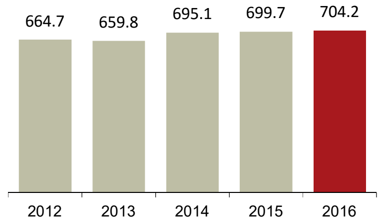
Profit after tax



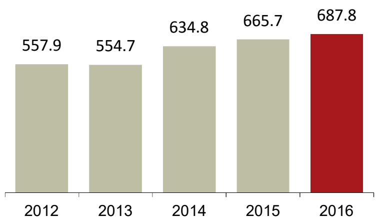
Earnings per share from continuing operations



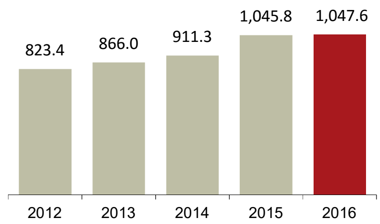
Risk weighted assets



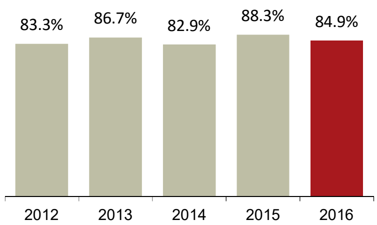
Loans to customers



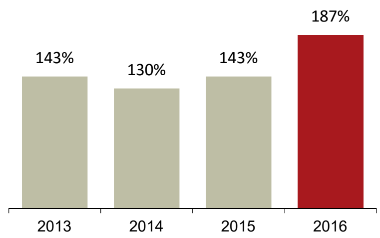
Total assets



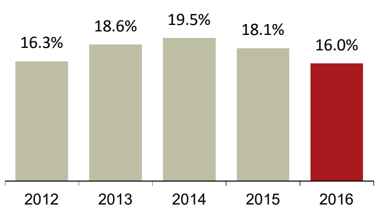
Deposit-to-loan ratio



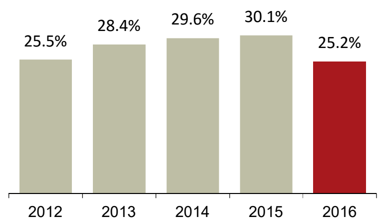
Liquidity coverage ratio



Leverage ratio



Total capital ratio



Directors' Report

The audited consolidated financial statements of Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) for the financial year 2016 comprise the financial statements of Íslandsbanki hf. and its subsidiaries, together referred to as “the Group”.

Operations in 2016

Íslandsbanki is a universal bank offering comprehensive financial services to households, corporations, and institutional investors in Iceland and overseas. The Group is one of Iceland's largest banking and financial services groups, with a strong domestic market share.

The Bank, which traces its roots back to 1875, builds on a solid heritage of lending to industry in Iceland. It has developed specific expertise in lending to the tourism, seafood, municipal, and energy sectors. With its focused approach in these fields, Íslandsbanki offers valuable services to industry players and investors.

The Bank is divided into six business segments: Retail Banking, Corporate Banking, Markets, Wealth Management, Treasury, and Subsidiaries & Equity Investments. The Bank operates a diverse and efficient branch network, with branches strategically located in the Reykjavík metropolitan area and in larger towns across the country. At the end of 2016, the Group employed 1,075 full-time members of staff, including 910 within the Bank itself, 64% female and 36% male.

The profit from the Group's operations for the financial year 2016 amounted to ISK 20.2 billion, which corresponds to a 10.2% return on equity. The Group's total equity amounted to ISK 178.9 billion and total assets were ISK 1,047.6 billion as of year-end 2016. The Group's total capital ratio, calculated according to the Act on Financial Undertakings, was 25.2%, well above the current short-term target of 23%. The year-end liquidity position was strong and well above the regulatory minimum and the leverage ratio remained very high compared to international peers at 16%.

The net income of the Group was heavily impacted by Borgun's, a subsidiary of the Bank, sale of its stake in Visa Europe, which resulted in a financial gain of ISK 6.2 billion. For further information on the Visa Europe transaction please refer to Note 13 to the consolidated financial statements.

In 2016, the Bank paid in total ISK 37 billion in dividends to the Icelandic State Treasury. In addition to the regular annual dividend, the Bank paid in December an ISK 27 billion special dividend due to accumulated profit from previous years.

In line with the Bank's published dividend policy of a 40-50% dividend payout ratio, the Board of Directors proposes that ISK 10 billion of 2016 net profit will be paid in dividends to shareholders, with the balance retained for the Bank's future development. The Board may convene a special shareholders' meeting later in the year to propose payment of an additional dividend if the Bank's accumulated capital reserves are considered to exceed its long-term capital requirements.

The Icelandic economy continued to perform strongly in 2016. Inflation was 1.7% over the year and has been below the Central Bank of Iceland's (CBI) target three years in a row. The unemployment rate was at 2.6% at year-end 2016, which by most measures constitutes full employment. GDP is expected to have grown by about 5.9% over the year, largely supported by the continued phenomenal growth in tourism. The Icelandic króna strengthened by close to 18% during the year on the back of positive currency flows.

The Icelandic government and CBI have continued to take measured steps towards the lifting of capital controls. As a result, individuals can now invest parts of their savings abroad, local businesses can more easily grow outside of Iceland and the domestic pension funds can diversify their holdings, which amounted to 146% of GDP at year-end 2016.

We saw modest growth of 3% in the Bank's loan portfolio in 2016 and new lending, including refinancing, amounted to over ISK 200 billion in total, supported by the overall increase in economic activity, while at the same time repayments remain high. Lending activity was strongest in mortgages and loans towards the tourism industry, which increases from 10% to 13% as a proportion of the overall loan book. The quality of the loan book continues to improve and the ratio of non-performing loans has decreased to 1.8% at the end of 2016, from 2.2% the year before.

In Q3 2016 Íslandsbanki issued a 4-year EUR 500 million (ISK 65 billion) benchmark note. The proceeds of the transaction were largely used to refinance existing facilities, including a EUR 138 million Tier 2 instrument and therefore at the end of 2016, the capital base fully consisted of core equity Tier 1 capital. The transaction was more than twice oversubscribed and placed with investors in the UK, Scandinavia and continental Europe. In the domestic market, the Bank was a frequent issuer of covered bonds, with total issuance of ISK 20 billion in 2016. Customer deposits remained about flat in 2016. At the same time concentration in the deposit base was substantially reduced and the proportion of deposits coming from the top ten depositors went from 24% to 15%.

In October, S&P upgraded the Bank's rating to BBB/A-2, with a positive outlook. The outlook reflects positive trends in the Icelandic economy and the banking sector and the Bank's successful restructuring of its loan book.

At the end of 2016, the Bank moved its headquarters to a new building in Kópavogur. The relocation will be finalised in the first half of 2017 and allows the Bank to merge all headquarter units in one location in an activity-based working environment. We believe this will improve employee satisfaction and productivity and at the same time save costs. The Bank has also taken further steps towards optimising the branch network. In 2016 three branches were merged into one in the new headquarter building and in 2017 the branch in the old Kirkjusandur headquarters will be merged with the Sudurlandsbraut branch.

Our ambition is to provide the best banking services in Iceland. We are therefore proud to note that the Bank received the best score in the Icelandic Customer Satisfaction Index (Íslenska Ánægjuvogin) of all credit institutions in Iceland in 2013- 2016. Íslandsbanki was also named the best bank in Iceland by Euromoney, for the fourth consecutive year, and the bank of the year by the Banker. These recognitions provide us with encouragement to further improve our services for the benefit of our customers.

Directors' Report

Outlook

GDP growth in Iceland is expected to remain strong and the country's external position continues to improve. Modest public and non-public debt levels and continued growth in tourism support this picture. The strengthening of the Icelandic króna can however impact the export sectors and create new economic imbalances. The overall outlook for the economy remains favourable.

A new coalition Government was formed in Iceland in January 2017. In the Government's platform agreement, it is clearly stated that it is not ideal for the State to own a majority of the share capital in the domestic commercial banks. The Government plans to reduce the State's ownership in small steps and in accord with a broad consensus and through an open and transparent process.

The continued growth in the Icelandic economy suggests that the outlook for the Bank's core operations remains favourable. Based on customer perception, Íslandsbanki is the leading bank in Iceland and is seen to provide the best service to its customers and this gives an opportunity to grow the Bank's market share. Increased competition does however put a pressure on lending margins and income growth. Furthermore, the bank tax is a clear competitive disadvantage for the domestic commercial banks and will have a substantial impact on profitability going forward if the tax rate is kept at current levels. Foreign currency funding costs have come down substantially in the past few quarters and the Bank will seek opportunities to optimise its capital structure by issuing subordinated debt.

Operationally, two of the biggest projects for 2017 are to finalise the relocation of the Bank's headquarters and to replace the Bank's core banking systems for deposits and payments. After having replaced the legacy core systems, the Bank will strive to enhance customer experience with better access to services through electronic channels.

The Bank has a strong balance sheet, capital and liquidity position. This, along with changes in the IT infrastructure, will allow the Bank to continue to provide its customers with the best banking services in Iceland.

Risk management

The Bank is exposed to various risks. The management of these risks is an integral part of the Bank's operations. The ultimate responsibility for ensuring an adequate risk management framework lies with the Board of Directors. The Board defines and communicates the acceptable level of risk through the Bank's risk management policies and the CEO is responsible for ensuring that risks are managed within those limits.

In January 2017, the Board approved certain changes to the risk management framework and internal controls. The aim of those changes is to clarify the responsibilities of each of the Bank's three lines of defence and further improve the Bank's risk culture.

The Bank's risk management framework and policies are discussed under Notes 58-83 to the consolidated financial statements and in the unaudited Pillar 3 Report.

Ownership

Íslandsbanki is wholly owned by the Icelandic State Treasury, directly (99.9%) and through its subsidiary ISB Holding ehf. (0.1%). The shares are administered by the Icelandic State Financial Investments (ISFI – Bankasýsla ríkisins) on its behalf. At the end of January 2016 the Bank's previous owner, Glitnir hf., signed a composition agreement to transfer its 95% share ownership in the Bank to the Icelandic Government as part of a stability contribution. The change of control was approved by the competition authorities in March 2016 and the shares transferred to the Icelandic State Treasury.

At the Bank's Annual General Meeting in April a new Board of Directors was elected for the Bank. The Board consists of seven members, four female and three male. The Board members are Anna Thórdardóttir, Audur Finnbogadóttir, Árni Stefánsson, Hallgrímur Snorrason, Heidrún Jónsdóttir, Helga Valfells and Fridrik Sophusson, as Chairman of the Board. Herdís Gunnarsdóttir and Pálmi Kristinsson were elected as Board alternates.

Corporate governance

Good governance practices are essential for long-term performance of companies as they improve work habits, transparency and accountability, and therefore protect and enhance the interests of shareholders as well as other stakeholders. The Board of Directors of Íslandsbanki is committed to excellence in its governance framework so that it reflects compliance with the best corporate governance practices in the financial market at all times.

Íslandsbanki was first recognised as “Exemplary in Corporate Governance” in March 2014 by the Center of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in March 2015 and 2016 and again in February 2017.

Íslandsbanki's management structure consists of the CEO and the Board of Directors, comprising seven non-executive directors and two alternates. The Board undertakes the Bank's affairs and is responsible for setting the Bank's general strategy as well as instructing the CEO on its further implementation and execution. The Board has a supervisory role overseeing that the Bank's organisation and activities are at all times in accordance with relevant law, regulations and good business practices. Furthermore, the Board shall monitor the execution of its policies, the sound control of accounting and financial management, and ensure that group internal audit, compliance, risk management and internal controls are effective at all times.

Directors' Report

Candidates for board membership are nominated through a selection process administered by Icelandic State Financial Investments (ISFI) in accordance with Article 7 of the ISFI Act no. 88/2009. The Articles of Association of the Bank provide that the ratio of each gender on the Board shall not be lower than 40%, currently the Board is comprised of four women and three men. In other respects than the foregoing, the Board has not set a specific policy on Board diversity.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. Three subcommittees are currently in operation: Board Audit Committee, Board Risk committee and Board Corporate Governance, Compensation and Human Resource Committee. The mandate letters of Board subcommittees are available on the Bank's website.

The CEO is responsible for the day-to-day operations of the Bank pursuant to set policies and resolutions of the Board of Directors. Moreover the CEO is required to ensure that the Bank's operations are at all times consistent with the Bank's Articles of Association and applicable legislation. An Executive Board is appointed by the CEO, consisting of nine members, including the CEO. The role of the Executive Board is to maintain an overview of the Bank's operations and to coordinate key aspects of its activities that are not supervised by other management committees.

The CEO ensures that the Board is regularly provided with accurate information on the Bank's finances, development and operations.

The Bank's Finance division is responsible for the preparation of the Bank's consolidated financial statements in line with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review and audit annual consolidated financial statements. An evaluation of weaknesses in the Bank's internal controls in relation to the accounting process is included in the external auditors report to the Board Audit Committee. The Risk management notes to the consolidated financial statements form part of the accounting process, see further notes 58-83 of the consolidated financial statements.

The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable laws and regulations, including those imposed by the FME, the Central Bank of Iceland and Nasdaq Iceland. The applicable laws include the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Public Limited Companies no. 2/1995 and the Act on Competition no. 44/2005, available on the Icelandic legislature's website (www.althingi.is).

The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland, available on www.corporategovernance.is (hereinafter the Guidelines). The Bank's practices are in compliance with the Guidelines except for certain items in Articles 1.5 and 2.9 of the Guidelines.

Article 1.5 of the Guidelines provides that the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by ISFI in accordance with article 7 of the ISFI Act.

Article 2.9 of the Guidelines provides that the Board sets a policy of social responsibility and a code of ethics. The Executive Board of the Bank adopted a code of conduct for the Bank in January 2011 which all employees were involved in formulating. The Board will be adopting a new code of ethics in the year 2017.

A more detailed description on Íslandsbanki's governance framework and associated practices can be found in the Bank's Corporate Governance Statement enclosed in an unaudited Appendix to the consolidated financial statements and on the Bank's webpage, www.islandsbanki.is.

Corporate social responsibility

Íslandsbanki adheres to a policy of corporate social responsibility with the aim to have a positive effect on society. The policy was implemented in 2015 and the focus is on nine key projects. Every year the Bank submits a corporate social responsibility report that fulfils the G4 sustainability reporting guidelines issued by independent GRI organisation. The report examines the policy and progress of projects that relate to corporate social responsibility. The report also covers issues related to the environment, employees and human rights. In 2016 the Helping Hand project was one of the Bank's key projects where employees devote one working day per year to a good cause and provide various charities with assistance. About 40% of employees took part in 2016 and the goal for 2017 is to have 50% employee participation in the Helping Hand project.

Directors' Report

Statement by the Board of Directors and the CEO

The audited consolidated financial statements for the year ended 31 December 2016 have been prepared on a going concern basis in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union; the Act on Annual Accounts, no. 3/2006; the Act on Financial Undertakings, no. 161/2002; and rules on accounting for credit institutions, where applicable, to the extent that they are not inconsistent with the requirements of the IFRS as adopted by the EU.

The Board notes that the Bank maintains a strong capital and liquidity position and is therefore well positioned to meet future risks and challenges.

To the best of our knowledge, these consolidated financial statements provide a true and fair view of the Group's operating profits and cash flows in 2016 and its financial position as of 31 December 2016. It also describes the principal risks and uncertainties currently faced by the Group.

The Board of Directors and the CEO have discussed the 2016 consolidated financial statements of Íslandsbanki and confirmed them with their signatures today.

Kópavogur, 24 February 2017

Board of Directors:

Fridrik Sophusson, Chairman
Helga Valfells, Vice-Chairman
Anna Thórdardóttir
Audur Finnbogadóttir
Árni Stefánsson
Hallgrímur Snorrason
Heidrún Jónsdóttir

Chief Executive Officer:

Birna Einarsdóttir

Independent Auditor's Report

To the Board of Directors and shareholders of Íslandsbanki hf.

Opinion

We have audited the consolidated financial statements of Íslandsbanki hf. and it subsidiaries (the Group) which comprise the consolidated statement of financial position as at 31 December 2016 and the consolidated income statement, consolidated statement of profit and loss and other comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flow for the year then ended and a summary of significant accounting policies and other explanatory information.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2016, and its consolidated financial performance and its consolidated cash flows for the year then ended, in accordance with the International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Account, Act on Financial Undertakings and rules on accounting for credit institution, where applicable.

Basis for Opinion

We conducted our audit in accordance with the International Standards on Auditing (ISAs). Our responsibilities are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the financial statements in Iceland, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matter

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Assessment of loan impairment allowances

Loans to customers represent ISK 687.840 million or 66% of total assets at 31 December 2016 against which impairment allowances of ISK 13.521 million have been recorded. Impairment allowances are calculated individually, for individually significant loans where objective evidence of impairment is identified, or collectively for groups of loans which are not assessed individually, and for which objective evidence of impairment is identified on a portfolio basis. The identification of impairment events and the determination of the recoverable amount is an inherently uncertain process involving various assumptions and factors including the financial condition of the counterparty, expected future cash flows, observable market prices and expected net selling prices. The use of different modelling techniques and assumptions could produce significantly different estimates of loan impairment allowances. The assessment of loan loss allowances is a key area of judgment for management in the consolidated financial statements. Due to the significance of loans and the related estimation uncertainty, we have assessed loan loss allowances as a key audit matter.

Auditor's Response

We assessed and tested the design and operating effectiveness of the controls over impairment identification and calculations.

For loan impairment allowances calculated on an individual basis, our test of controls included testing: controls over the process and guidelines used by business units in reviewing loans for impairment, the credit file review process, controls over inputs into impairment assessments, the loan system’s calculation of days in default, the preparation and review of reconciliations by management of the impairment system to the accounting system and controls over the review and approval of significant individual impairments.

We tested management’s inputs into the impairment assessment, on an individual basis, for a risk based sample of loans. Our sample was based on various factors, among others, default status, internal risk rating, legal collection status, significant impairments or reversals during the year as well as sector information both in domestic and foreign markets.

For loan impairment allowance calculated on a collective basis our test of controls included controls over management’s review and approval of the collective impairment calculations. We also assessed the methodology used with reference to International Financial Reporting Standards. We tested the collective impairment calculations through re-performance, adherence to management’s methodology as well as testing management’s model validations.

The basis of the loan impairment allowances is summarised in the significant accounting policies, in Note 4 “Use of significant estimates and judgments in applying accounting policies”, in Notes 24, 31, 32 and credit risk notes 59 - 67.

Other information in the Annual report of Íslandsbanki hf. for the year 2016

Other information consists of the information included in Íslandsbanki hf. 2016 Annual Report other than the consolidated financial statements and our auditor’s report thereon. Management and Board of Directors are responsible for the other information.

Our opinion on the consolidated financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

Independent Auditor's Report

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed on the other information obtained prior to the date of the auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of CEO and Board of Directors for the Financial Statements

The Chief Executive Officer (CEO) and Board of Directors is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards, as adopted by the European Union and additional requirements in the Icelandic Act on Annual Accounts, Act on Financial Undertakings and rules on accounting for credit institution, where applicable.

The CEO and Board of Directors is responsible for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

The Board of Directors are responsible for overseeing the Group's consolidated financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with International Standards on Auditing (ISAs) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with the International Standards on Auditing (ISAs), we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

•Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

•Obtain an understanding of internal control relevant to the audit 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 Group's internal control.

•Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

•Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

•Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

•Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

Independent Auditor's Report

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor’s report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on the Board of Directors report

Pursuant to the legal requirements of Article 104, Paragraph 2 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 consolidated financial statements includes all information required by the Icelandic Financial Statement Act.

Reykjavík, 24 February 2017

Margrét Pétursdóttir
State Authorised Public Accountant

Ernst & Young ehf.
Borgartúni 30
105 Reykjavík

Consolidated Income Statement for the year 2016

	Notes	2016	2015
Interest income	11	60,503	53,414
Interest expense	11	(28,701)	(25,404)
Net interest income		31,802	28,010
Fee and commission income	12	21,818	20,737
Fee and commission expense	12	(8,095)	(7,567)
Net fee and commission income		13,723	13,170
Net financial income	13-16	6,096	3,881
Net foreign exchange gain (loss)	17	443	(1,490)
Other operating income	18	652	1,102
Other net operating income		7,191	3,493
Total operating income		52,716	44,673
Salaries and related expenses	19-21	(14,789)	(13,891)
Other operating expenses	22	(12,332)	(9,869)
Contribution to the Depositors' and Investors' Guarantee Fund		(1,063)	(1,067)
Bank tax	86.27	(2,843)	(2,878)
Total operating expenses		(31,027)	(27,705)
Profit before net loan impairment		21,689	16,968
Net loan impairment	24	735	8,135
Profit before tax		22,424	25,103
Income tax expense	26	(5,205)	(5,851)
Profit for the year from continuing operations		17,219	19,252
Profit from discontinued operations, net of income tax	25	2,939	1,326
Profit for the year		20,158	20,578

	Notes	2016	2015
Profit attributable to:			
Equity holders of Íslandsbanki hf.		16,947	20,000
Non-controlling interests		3,211	578
Profit for the year		20,158	20,578
Earnings per share from continuing operations			
Basic and diluted earnings per share attributable to the shareholders of Íslandsbanki hf.	27	1.40	1.87

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

AMOUNTS ARE IN ISK MILLION

Consolidated Statement of Profit or Loss and other Comprehensive Income for the year 2016

	Notes	2016	2015
Profit for the year		20,158	20,578
Other comprehensive income			
Items that are or may be reclassified to profit or loss			
Foreign currency translation differences for foreign operations	53	(52)	9
Fair value reserve (available for sale financial assets):			
Net change in fair value, tax exempt		702	5,445
Net amount reclassified to profit or loss		(6,186)	-
Other comprehensive income for the year, net of tax		(5,536)	5,454
Total comprehensive income for the year		14,622	26,032

		2016	2015
Total comprehensive income attributable to:			
Equity holders of Íslandsbanki hf.		13,412	23,467
Non-controlling interests		1,210	2,565
Total comprehensive income for the year		14,622	26,032

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

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Consolidated Statement of Financial Position as at 31 December 2016

	Notes	31.12.2016	31.12.2015
Assets			
Cash and balances with Central Bank	28	275,453	216,760
Bonds and debt instruments	7	31,256	78,606
Shares and equity instruments	7	10,626	18,320
Derivatives	29	1,953	1,981
Loans to credit institutions	30	17,645	35,534
Loans to customers	31-32	687,840	665,711
Investments in associates	33-34	450	716
Property and equipment	38	6,211	7,344
Intangible assets	39	2,672	1,331
Other assets	40	7,064	6,674
Non-current assets and disposal groups held for sale	41	6,384	12,792
Total Assets		1,047,554	1,045,769
Liabilities			
Deposits from Central Bank and credit institutions	42	4,922	25,631
Deposits from customers	43-44	594,187	593,245
Derivative instruments and short positions	29	4,798	6,981
Debt issued and other borrowed funds	46	212,468	150,308
Subordinated loans	47	-	19,517
Tax liabilities	48-50	8,473	8,358
Other liabilities	51	43,456	36,677
Non-current liabilities and disposal groups held for sale	41	325	2,825
Total Liabilities		868,629	843,542
Equity			
Share capital	52	10,000	10,000
Share premium	52	55,000	55,000
Reserves		4,139	6,002
Retained earnings		105,563	127,288
Total equity attributable to the equity holders of Íslandsbanki hf.		174,702	198,290
Non-controlling interests		4,223	3,937
Total Equity		178,925	202,227
Total Liabilities and Equity		1,047,554	1,045,769

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

AMOUNTS ARE IN ISK MILLION

Consolidated Statement of Changes in Equity for the year 2016

	Notes	Share capital	Share premium	Fair value reserve	Other reserves	Retained earnings	Total	Non-controlling interests	Total equity
		Attributable to the equity holders of Íslandsbanki hf.							
Equity as at 1.1.2015		10,000	55,000	-	2,535	116,288	183,823	1,664	185,487
Translation differences for foreign operations	53				9		9		9
Net change in fair value of AFS financial assets				3,458			3,458	1,987	5,445
Profit for the year						20,000	20,000	578	20,578
Dividends paid						(9,000)	(9,000)	(292)	(9,292)
Equity as at 31.12.2015		10,000	55,000	3,458	2,544	127,288	198,290	3,937	202,227
Equity as at 1.1.2016		10,000	55,000	3,458	2,544	127,288	198,290	3,937	202,227
Translation differences for foreign operations	53				(52)		(52)		(52)
Net change in fair value of AFS financial assets				445			445	257	702
Net amount reclassified to profit or loss				(3,928)			(3,928)	(2,258)	(6,186)
Profit for the year						16,947	16,947	3,211	20,158
Dividends paid						(37,000)	(37,000)	(835)	(37,835)
Changes in non-controlling interests							-	(89)	(89)
Restricted due to capitalised development cost	53				1,302	(1,302)	-		-
Restricted due to fair value changes	53				113	(113)	-		-
Restricted due to subsidiaries and associates	53				257	(257)	-		-
Equity as at 31.12.2016		10,000	55,000	(25)	4,164	105,563	174,702	4,223	178,925

Dividend:
The Annual General Meeting ("AGM") for the operating year 2015 was held on 19 April 2016. At the AGM shareholders approved the Board's proposal to pay dividends to shareholders for the financial year 2015 of up to 50% of net profit. It was also approved that a special shareholders meeting may be convened later in the year where an extraordinary dividend payout could be suggested. Dividends amounting to ISK 10,000 million were paid on 27 April 2016 and an extraordinary dividend amounting to ISK 27,000 million, approved of at a shareholders meeting held on 20 December 2016, was paid out on 28 December 2016. In total, Íslandsbanki paid a total of ISK 37,000 million in dividends to the Icelandic State Treasury in 2016, equivalent to ISK 3.70 per share (2015: ISK 0.90 per share).

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

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Consolidated Statement of Cash Flows for the year 2016

	Notes	2016	2015
Cash flows from operating activities:			
Profit for the year		20,158	20,578
Adjustments to reconcile profit for the year to cash flows provided by (used in) operating activities:			
Non-cash items included in profit for the year and other adjustments		12,772	2,860
Changes in operating assets and liabilities		(60,259)	58,569
Dividends received		209	681
Income tax and bank tax paid		(8,097)	(8,386)
Net cash (used in) provided by operating activities		(35,217)	74,302
Cash flows from investing activities:			
Net investments in associated companies		(84)	(33)
Proceeds from sale of property and equipment		785	71
Purchase of property and equipment	38	(1,270)	(743)
Purchase of intangible assets	39	(1,493)	(848)
Net cash (used in) investing activities		(2,062)	(1,553)
Cash flows from financing activities:			
Proceeds from borrowings		103,421	76,395
Repayment of borrowings		(48,116)	(24,318)
Dividends paid		(10,000)	(9,000)
Dividends paid non-controlling interests		(835)	(292)
Net cash provided by financing activities		44,470	42,785
Net increase in cash and cash equivalents		7,191	115,534
Effects of foreign exchange rate changes		(355)	(127)
Cash and cash equivalents at the beginning of the year		233,427	118,020
Cash and cash equivalents at year-end		240,263	233,427

	Notes	2016	2015
Reconciliation of cash and cash equivalents:			
Cash on hand	28	3,073	2,784
Cash balances with Central Bank	28	272,380	213,976
Bank accounts	30	12,003	31,646
Mandatory reserve and special restricted balances with Central Bank	28	(47,193)	(14,979)
Cash and cash equivalents at year-end		240,263	233,427

The Group has prepared its consolidated statement of cash flows using the indirect method. The statement is based on the net profit after tax for the year and shows the cash flows from operating, investing and financing activities and the increase or decrease in cash and cash equivalents during the year. Cash and cash equivalents consist of highly liquid assets that are readily convertible into cash and which are subject to an insignificant risk of change in value. These are cash on hand, unrestricted balances with Central Bank and demand deposits with credit institutions.

Interest received in 2016 was ISK 61,551 million (2015: ISK 55,349 million) and interest paid in 2016 was ISK 26,235 million (2015: ISK 24,404 million). Interest paid is defined as having been paid when it has been deposited into the customer account and is available for the customer's disposal.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

AMOUNTS ARE IN ISK MILLION

Consolidated Statement of Cash Flows for the year 2016

Non-cash items included in profit for the year and other adjustments:	2016	2015
Depreciation and impairment	1,920	672
Amortisation of intangible assets	152	136
Share of loss (gain) of associates	122	(113)
Accrued interest and foreign exchange gain on debt issued	6,340	4,258
Impairment on loans	779	3,184
Reversal of impairment previously recorded against loans	(1,514)	(11,319)
Foreign exchange (gain) loss	(443)	1,490
Net (gain) loss on sale of property and equipment	(303)	57
Unrealised fair value losses (gains) recognised in profit and loss	610	(2,908)
Net profit on non-current assets classified as held for sale	(2,939)	(1,326)
Bank tax	2,843	2,878
Income tax	5,205	5,851
Non-cash items included in profit for the year and other adjustments	12,772	2,860
Changes in operating assets and liabilities:		
Mandatory reserve and special restricted balances with Central Bank	(32,214)	(5,427)
Loans and receivables to credit institutions	(5,326)	7,140
Loans and receivables to customers	(41,610)	(29,172)
Trading assets	18,356	4,309
Other operating assets	(1,321)	1,049
Non-current assets and liabilities held for sale	7,352	9,796
Deposits with credit institutions and Central Bank	(20,659)	(166)
Deposits from customers	15,403	68,503
Trading financial liabilities	(3,598)	3,387
Derivatives	1,443	(540)
Other operating liabilities	1,915	(310)
Changes in operating assets and liabilities	(60,259)	58,569

Non-cash transactions 2016

During 2016 the Group entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) Subordinated loan of ISK 17,820 million was paid up in the year 2016 by issuing bonds. The transaction had no cash effect on the Group.

b) In 2016 the Bank paid dividends amounting to ISK 37,000 million. Thereof are non-cash transactions amounting to ISK 21,600 million which were paid with a government bond and capital income tax amounting to ISK 5,400 million, due in February 2017.

Non-cash transactions 2015

During 2015 the Group entered into the following non-cash investing and financing activities which have been excluded from the consolidated statement of cash flows:

a) The Group recognised fair value changes of ISK 5,445 million in 2015 which had no cash effect on the Group.

The notes on pages 17 to 88 are an integral part of these consolidated financial statements.

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

Notes to the Consolidated Financial Statements

1. Corporate information

Íslandsbanki hf. the parent company was incorporated on 8 October 2008 and is a limited liability company domiciled in Iceland. The address of its registered office is Hagasmári 3, 201 Kópavogur, Iceland.

The consolidated financial statements for the year ended 31 December 2016 comprise Íslandsbanki hf. (“the Bank” or “Íslandsbanki”) and its subsidiaries together referred to as "the Group".

At the end of 2016 the Bank was wholly owned by the Icelandic Government, directly and through its subsidiary ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments in accordance with Act no. 88/2009 on Icelandic State Financial Investments.

The Group provides a wide range of financial services such as retail banking, corporate banking, investment banking, wealth management and asset financing. The Group operates mainly in the Icelandic market.

2. Basis of preparation

The consolidated financial statements have been prepared in accordance with the International Financial Reporting Standards (IFRS) as adopted by the European Union and additional requirements in the Act on Annual Accounts no. 3/2006, the Act on Financial Undertakings no. 161/2002 and rules on accounting for credit institutions.

The consolidated financial statements were approved and authorised for issue by the Board of Directors and the CEO of Íslandsbanki hf. on 24 February 2017.

The Group's management has made an assessment of the Group's ability to continue as a going concern and is satisfied that the Group has the resources to continue in business for the foreseeable future. Therefore, these consolidated financial statements have been prepared on a going concern basis.

3. Functional and presentation currency

These consolidated financial statements are presented in Icelandic króna (ISK), which is the functional currency of Íslandsbanki hf. All amounts presented in ISK have been rounded to the nearest million, except when otherwise indicated. At year-end the exchange rate of the ISK against the USD was 112.82 and 119.13 for the EUR (2015: USD 129.59 and EUR 141.32).

4. Use of significant estimates and judgements in applying accounting policies

The preparation of the consolidated financial statements 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 recognised. Although these estimates are based on management's best knowledge of current events and actions, actual results may ultimately differ from those estimates.

The Group's management discusses with the Audit Committee the development, selection and disclosure of the Group's critical accounting policies and their application, and assumptions made relating to major estimation uncertainties. Information about assumptions and estimation uncertainties that have a significant risk of resulting in a material adjustment within the next financial year and about critical judgements in applying accounting policies that have the most significant effect on the amounts recognised in the consolidated financial statements.

Impairment of loans measured at amortised cost

The key sources of estimation uncertainty are within impairment losses and reversal of impairment losses of loans. The Group's management reviews its loan portfolios on a quarterly basis to assess whether there is any objective evidence of impairment. In determining whether an impairment loss should be recognised in the income statement, the Group's management makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from loans and receivables. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group. 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. For more information see Note 24, Credit Risk Notes 59 to 67 and Note 86.28.

Notes to the Consolidated Financial Statements

Operating segments

5. The Group is organised into six main operating segments based on products and services:

a) Retail Banking
Retail Banking, the Bank's largest division, provides wide-ranging financial services to individuals and SMEs. Comprehensive consultancy services are conducted by our experienced advisors, 50 of whom are certified financial advisors located throughout the branches and in the call centre. In addition to operating Iceland's most efficient branch network, Retail Banking also operates Kreditkort, a specialised brand in the credit card sector.

b) Corporate Banking
Corporate Banking provides lending and structured finance services to larger companies, institutions, and municipalities, as well as providing project financing for infrastructure, industrial, and public service projects. Through Ergo, the division also offers asset-based financing to corporations and individuals. Corporate banking has extensive experience servicing established sectors such as seafood, energy, and real estate, as well as growing industries such as retail and tourism. Íslandsbanki has developed a focused strategy for lending outside Iceland, concentrating on the North Atlantic seafood industry.

c) Markets
Markets, the Bank's investment banking division, leads the growth of a healthy financial market by offering multifaceted financial services that enable our customers to achieve their strategic goals. The division's main customers are large and medium-sized companies, financial institutions, pension funds, investment funds, and other investors. The division's services include corporate finance, capital markets, derivatives, foreign exchange, and market research.

d) Wealth Management
The Bank's wealth management division is comprised of two units: VÍB and Íslandssjódir hf., a subsidiary of the Bank. VÍB offers comprehensive asset management and private banking services to both private investors and institutional clients, including portfolio management services for affluent individuals and institutional investors, and advisory, investment, and pension services for retail investors. Íslandssjódir hf. is an independent fund management company offering a full range of fund products, including bond, stock, multi-asset, and alternative investment funds. Wealth Management also comprised Summa Rekstrarfélag hf. for part of the year as a subsidiary of the Bank. At year-end Summa Rekstrarfélag hf. was an associate of the Bank.

e) Treasury
Treasury is responsible for funding the Bank's operations and for managing an internal pricing framework. The division is also responsible for sharing information regarding the financial position of the Group, and for each of its individual units, to the relevant parties inside and outside the Group. Treasury is responsible for the Group's annual budgeting process and management of the Bank's liquidity risk, foreign exchange risk, inflation risk and interest rate risk within regulatory requirements and internal limits established by the Board of Directors. The division also manages relations with investors, financial institutions, stock exchanges and rating agencies.

f) Subsidiaries & Equity Investments
Subsidiaries & Equity Investments include equity investments in the banking book and subsidiaries, the most significant being:
• Borgun hf., a payment acquirer and issuing processor.
• Allianz Ísland hf., an agent for the German insurance company Allianz, and its holding company Hringur eignarhaldsfélag ehf.
• D1 ehf., a commercial real estate company which holds and manages a portfolio of properties for leasing, thereof 11 properties leased by the Group.

Cost centres comprise Head Office, Human Resources, Legal, Risk Management, Finance, Operations & IT, Group Internal Audit, Compliance and Business Development.

The accounting policies for the reportable segments are in line with the Group's accounting policies. The Group operates mainly in the Icelandic market and no single customer generates 10% or more of the combined revenue of the Group.

On the following page is an overview showing the Group's performance with a breakdown by operating segments as well as reconciliation to the Group's total profit before tax.

Notes to the Consolidated Financial Statements

5. Cont'd

The year 2016

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	18,176	7,114	838	604	4,662	748	(340)	31,802
Net fee and commission income	4,758	523	1,494	2,015	(109)	5,017	25	13,723
Other operating income	123	39	291	2	209	8,279	(1,752)	7,191
Total operating income	23,057	7,676	2,623	2,621	4,762	14,044	(2,067)	52,716
Salaries and related expenses	(3,988)	(1,023)	(1,011)	(997)	(135)	(2,158)	(5,477)	(14,789)
Other operating expenses	(3,099)	(371)	(226)	(232)	(249)	(2,935)	(5,220)	(12,332)
Deposit guarantee fund and bank tax	(976)	(6)	(0)	(69)	(2,855)	-	(0)	(3,906)
Net loan impairment	682	(265)	0	0	-	318	-	735
Profit (loss) before cost allocation & tax	15,676	6,011	1,386	1,323	1,523	9,269	(12,764)	22,424
Net segment revenue from external customers	20,164	17,257	3,275	529	(1,606)	14,813	(1,716)	52,716
Net segment revenue from other segments	2,893	(9,581)	(652)	2,092	6,368	(769)	(351)	0
Depreciation and amortisation	(326)	(54)	-	(3)	(0)	(940)	(749)	(2,072)
At 31 December 2016								
Loans to customers	409,855	272,282	227	0	0	6,460	(984)	687,840
Other assets	4,663	190	16,255	2,803	289,434	62,940	(16,571)	359,714
Total segment assets	414,518	272,472	16,482	2,803	289,434	69,400	(17,555)	1,047,554
Desposits from customers	439,632	1,783	9	34,692	122,655	6	(4,590)	594,187
Other liabilities	10,079	1,522	1,549	1,542	232,477	39,599	(12,326)	274,442
Total segment liabilities	449,711	3,305	1,558	36,234	355,132	39,605	(16,916)	868,629
Allocated equity	44,964	41,603	1,677	3,444	78,747	13,172	(4,682)	178,925

The individual segment balance sheet positions are with external customers, and exclude internal transactions thus explaining the differences in total assets and total liabilities and equity.

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

5. Cont'd

The year 2015

Operations	Retail Banking	Corporate Banking	Markets	Wealth Manage-ment	Treasury	Subsidiaries & Equity Investments	Cost Centres & Eliminations	Total
Net interest income	16,279	6,682	1,066	639	3,579	142	(377)	28,010
Net fee and commission income	4,156	495	1,520	2,208	(146)	4,932	5	13,170
Other operating income	41	18	415	314	(1,505)	4,690	(480)	3,493
Total operating income	20,476	7,195	3,002	3,161	1,928	9,764	(853)	44,673
Salaries and related expenses	(3,713)	(961)	(892)	(992)	(117)	(1,763)	(5,454)	(13,891)
Other operating expenses	(2,065)	(276)	(149)	(205)	(188)	(1,926)	(5,060)	(9,869)
Deposit guarantee fund and bank tax	(968)	(20)	(0)	(62)	(2,894)	(0)	-	(3,945)
Net loan impairment	2,936	4,594	(0)	187	-	560	(142)	8,135
Profit (loss) before cost allocation & tax	16,666	10,532	1,960	2,090	(1,271)	6,635	(11,509)	25,103
Net segment revenue from external customers	19,086	16,276	3,419	1,085	(5,368)	10,611	(435)	44,673
Net segment revenue from other segments	1,390	(9,081)	(417)	2,076	7,297	(848)	(417)	0
Depreciation and amortisation	(185)	(9)	(1)	(3)	(0)	(188)	(420)	(808)
At 31 December 2015								
Loans to customers	393,712	268,577	152	0	(0)	5,450	(2,180)	665,711
Other assets	4,149	589	11,680	4,124	308,166	68,683	(17,334)	380,057
Total segment assets	397,861	269,166	11,833	4,124	308,166	74,133	(19,514)	1,045,769
Desposits from customers	401,049	7,511	7	42,368	146,162	82	(3,934)	593,245
Other liabilities	13,180	1,747	5,057	1,741	201,046	41,315	(13,790)	250,297
Total segment liabilities	414,229	9,258	5,064	44,109	347,208	41,398	(17,724)	843,542
Allocated equity	42,924	39,577	2,898	3,130	101,749	19,046	(7,097)	202,227

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

Quarterly statements

6. Operations by quarters:

2016	Q4*	Q3*	Q2*	Q1*	Total
Net interest income	8,149	7,758	8,356	7,539	31,802
Net fee and commission income	3,831	3,233	3,515	3,144	13,723
Net financial income**	37	(607)	6,062	604	6,096
Net foreign exchange gain	77	49	305	12	443
Other operating income	(17)	45	473	151	652
Salaries and related expenses	(4,061)	(3,092)	(3,697)	(3,939)	(14,789)
Other operating expenses	(3,331)	(2,521)	(3,902)	(2,578)	(12,332)
Contribution to the Depositors' and Investors' Guarantee Fund	(252)	(283)	(267)	(261)	(1,063)
Bank tax	(691)	(745)	(716)	(691)	(2,843)
Net loan impairment	484	(118)	689	(320)	735
Profit before tax	4,226	3,719	10,818	3,661	22,424
Income tax expense	(1,353)	(1,266)	(1,720)	(866)	(5,205)
Profit for the period from continuing operations	2,873	2,453	9,098	2,795	17,219
Profit from discontinued operations, net of income tax	1,730	85	409	715	2,939
Profit for the period	4,603	2,538	9,507	3,510	20,158

2015	Q4*	Q3*	Q2*	Q1*	Total
Net interest income	7,003	7,457	7,359	6,191	28,010
Net fee and commission income	3,235	3,512	3,518	2,905	13,170
Net financial income	1,455	387	275	1,764	3,881
Net foreign exchange (loss)	(137)	(1,072)	(141)	(140)	(1,490)
Other operating income	403	158	252	289	1,102
Salaries and related expenses	(3,670)	(3,340)	(3,421)	(3,460)	(13,891)
Other operating expenses	(2,848)	(1,970)	(2,688)	(2,363)	(9,869)
Contribution to the Depositors' and Investors' Guarantee Fund	(270)	(263)	(265)	(269)	(1,067)
Bank tax	(818)	(732)	(710)	(618)	(2,878)
Net loan impairment	409	3,418	1,977	2,331	8,135
Profit before tax	4,762	7,555	6,156	6,630	25,103
Income tax expense	(1,147)	(1,784)	(1,524)	(1,396)	(5,851)
Profit for the period from continuing operations	3,615	5,771	4,632	5,234	19,252
Profit from discontinued operations, net of income tax	274	128	762	162	1,326
Profit for the period	3,889	5,899	5,394	5,396	20,578

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

**For further information see Note 13.

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Notes to the Consolidated Financial Statements

Financial assets and liabilities

7. The following table shows the classification of financial assets and financial liabilities:

At 31 December 2016	Notes	Held for trading	Held for hedging	Designated at fair value through P&L	Loans & receivables	Available for sale	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	28	-	-	-	275,453	-	-	275,453
Loans and receivables								
Loans to credit institutions	30	-	-	-	17,645	-	-	17,645
Loans to customers	31-32	-	-	-	687,840	-	-	687,840
Loans and receivables		-	-	-	980,938	-	-	980,938
Bonds and debt instruments								
Listed		28,448	-	635	-	-	-	29,083
Unlisted		-	-	2,173	-	-	-	2,173
Bonds and debt instruments		28,448	-	2,808	-	-	-	31,256
Shares and equity instruments								
Listed		6,333	-	1,737	-	-	-	8,070
Unlisted		-	-	1,717	-	839	-	2,556
Shares and equity instruments		6,333	-	3,454	-	839	-	10,626
Derivatives	29	1,953	-	-	-	-	-	1,953
Other financial assets		-	-	-	6,293	-	-	6,293
Total financial assets		36,734	-	6,262	987,231	839	-	1,031,066
Deposits from CB and credit institutions	42	-	-	-	-	-	4,922	4,922
Deposits from customers	43-44	-	-	-	-	-	594,187	594,187
Derivative instruments and short positions .	29	4,413	385	-	-	-	-	4,798
Debt issued and other borrowed funds	46	-	-	-	-	-	212,468	212,468
Other financial liabilities		-	-	-	-	-	36,005	36,005
Total financial liabilities		4,413	385	-	-	-	847,582	852,380

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

7. Cont'd

At 31 December 2015	Notes	Held for trading	Held for hedging	Designated at fair value through P&L	Loans & receivables	Available for sale	Liabilities at amortised cost	Total carrying amount
Cash and balances with Central Bank	28	-	-	-	216,760	-	-	216,760
Loans and receivables								
Loans to credit institutions	30	-	-	-	35,534	-	-	35,534
Loans to customers	31-32	-	-	-	665,711	-	-	665,711
Loans and receivables		-	-	-	918,005	-	-	918,005
Bonds and debt instruments								
Listed		44,443	-	31,341	-	-	-	75,784
Unlisted		-	-	2,822	-	-	-	2,822
Bonds and debt instruments		44,443	-	34,163	-	-	-	78,606
Shares and equity instruments								
Listed		7,993	-	3,218	-	-	-	11,211
Unlisted		-	-	1,664	-	5,445	-	7,109
Shares and equity instruments		7,993	-	4,882	-	5,445	-	18,320
Derivatives	29	1,981	-	-	-	-	-	1,981
Other financial assets		-	-	-	5,535	-	-	5,535
Total financial assets		54,417	-	39,045	923,540	5,445	-	1,022,447
Deposits from CB and credit institutions	42	-	-	-	-	-	25,631	25,631
Deposits from customers	43-44	-	-	-	-	-	593,245	593,245
Derivative instruments and short positions .	29	6,981	-	-	-	-	-	6,981
Debt issued and other borrowed funds	46	-	-	-	-	-	150,308	150,308
Subordinated loans	47	-	-	-	-	-	19,517	19,517
Other financial liabilities		-	-	-	-	-	26,642	26,642
Total financial liabilities		6,981	-	-	-	-	815,343	822,324

AMOUNTS ARE IN ISK MILLION

Fair value information for financial instruments

8. Financial instruments carried at fair value

The fair value of a financial instrument is the transaction price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Where a market price is not readily available, the Group applies valuation techniques based on estimates and assumptions that are consistent with that which market participants would use in setting a price for the financial instrument. In some instances the Group uses approximation methods. These approximation methods are explained in more detail below.

The table below shows financial instruments carried at fair value at 31 December 2016 categorised into three levels of fair value hierarchy that reflect the type of inputs used in making the fair value measurements. The different levels have been defined as follows:

Level 1: Inputs that are quoted prices (unadjusted) in active markets for identical assets or liabilities that the Group can access at the measurement date.

Level 2: Inputs other than the quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).

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

At 31 December 2016

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	26,243	3,141	1,872	31,256
Shares and equity instruments	7,965	589	2,072	10,626
Derivative instruments	-	1,953	-	1,953
Total financial assets	34,208	5,683	3,944	43,835
Financial liabilities:				
Short positions	475	-	-	475
Derivative instruments	-	4,323	-	4,323
Total financial liabilities	475	4,323	-	4,798

At 31 December 2015

Financial assets:	Level 1	Level 2	Level 3	Total
Bonds and debt instruments	45,227	32,732	647	78,606
Shares and equity instruments	11,348	1,527	5,445	18,320
Derivative instruments	-	1,981	-	1,981
Total financial assets	56,575	36,240	6,092	98,907
Financial liabilities:				
Short positions	3,771	302	-	4,073
Derivative instruments	-	2,908	-	2,908
Total financial liabilities	3,771	3,210	-	6,981

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8. Cont'd

Reconciliation of financial instruments categorised into Level 3

	Bonds and debt instruments	Shares and equity instruments	Derivatives
Fair value at 1 January 2016	647	5,445	-
Purchases	113	906	-
Sales	(265)	(6,193)	-
Net gain on financial instruments recognised in profit or loss	6	29	-
Net gain on financial instruments recognised in other comprehensive income	-	702	-
Transfers from level 1 or 2	1,371	1,183	-
Fair value at 31 December 2016	1,872	2,072	-

	Bonds and debt instruments	Shares and equity instruments	Derivatives
Fair value at 1 January 2015	1,190	2,816	(93)
Purchases	-	689	-
Sales	-	(1,315)	-
Net (loss) gain on financial instruments recognised in profit or loss	(543)	818	(2)
Net gain on financial instruments recognised in other comprehensive income	-	5,445	-
Transfers to level 1 or 2	-	(3,008)	95
Fair value at 31 December 2015	647	5,445	-

The responsibility for the valuation at fair value of financial instruments lies with the relevant business units. Each quarter, the business units present a valuation report to the Investment Committee for approval. The report and its assumptions are reviewed by Risk Management.

Where applicable, fair values are determined using quoted prices in active markets for identical assets and liabilities. In other cases, where there is no active market, the fair value is estimated using valuation techniques such as net present value and discounted cash flow models; comparison with similar instruments for which observable market data exists; net asset value (NAV) for investment fund units or expected recovery for distressed bonds. These valuation techniques are based on various assumptions and inputs such as risk-free rate, expected revenue growth and credit and liquidity spreads. In some cases, where significant inputs into these models are not observable, expert judgement and estimation for these inputs are required.

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

Level 2 assets and liabilities contain illiquid bonds in the domestic markets, equities as well as derivatives. The Group classifies mutual fund units as shares and equity instruments in Level 2 and estimates the fair value for these units based on NAV where the unit prices are not readily available. For interest rate derivatives contracts such as interest rate swaps (IRS) and cross-currency interest rate swaps (CIRS) the Group calculates the net present value of estimated future cash flows based on yield curves with key inputs such as interest swap rates and forward-rate agreements (FRAs) rates. Foreign-currency forwards and foreign-currency swaps are valued using the FX spot rate adjusted for forward pricing points that can be obtained from market sources. These products are classified as Level 2. Bond forwards and equity forwards are also classified as Level 2 as they are valued using standard models with key inputs observed from stock prices, estimated dividend rates and funding rates. In general bond options are classified as Level 2.

Level 3 assets contain primarily unlisted and illiquid equities and bonds. Unlisted equities are initially booked at their transaction price but are revalued each quarter based on the models as described above. At year-end 2016, the Group's Level 3 equities amounted to ISK 2.072 million. In 2016 the Group obtained Series C preferred shares in Visa Inc. in relation to the sale of its shares in Visa Europe. The shares are subject to selling restrictions for a period of up to 12 years and under certain conditions may have to be recalled. The shares are classified as Level 3 for the valuation of the fair value, amounted to ISK 819 million at 31 December 2016.

The Group's Level 3 bonds amounted to ISK 1,872 million and were valued based on discounted expected recovery of the bond issuers' assets. The expected recovery of these bonds ranges from 0% to 100% and is subject to uncertainty regarding various assumptions, such as the outcome of legal disputes. An increase or decrease in the expected recovery would result in a similar change in the fair value. The majority of the amount in Level 3 bonds is estimated by discounting cash flow where the yield is the contractual currency's base rate with a premium that is decided by expert judgement on project risk and financing cost.

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9. Financial instruments not carried at fair value

Assets

Loans to customers, on the Group's statement of financial position, that are carried at amortised cost consist of two types:

1) Loans whose carrying amount is less than their claim value, due to either impairments or deep discount.
2) Loans whose carrying amount equals the claim value.

Loans in category 1) are specifically assessed for impairment on quarterly basis and therefore their carrying amount is considered a good approximation of their fair value. Since measurement is partially based on internal models they are classified as Level 3.

The fair value of the loans in category 2) may differ from their carrying amount because the interest rate they carry may not reflect the interest rate that similar new loans would carry. This difference stems from two sources:

a) Credit migration: The debtors may not have the same credit-worthiness they had when the loans' interest rates were last reset and the collateralisation of the loan may have changed.
b) Fixed rate loans: The interest rate level used as a base for pricing fixed rate loans may have shifted.

The Group calculates the fair value of loans in category 2) by discounting from the carrying amount the resulting interest rate difference from 31 December 2016 to the loan's next interest reset or maturity, whichever comes first. Since the credit-worthiness is estimated using the Group's internal models these assets are classified as Level 3.

For “Cash and balances with Central Bank”, “Loans to credit institutions” and “Other financial assets” the fair value is very well approximated by the carrying amount since they are short term in nature. They are thus classified as Level 2.

Liabilities

The fair value of a financial liability with a demand feature, such as a demand deposit, is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. On the liabilities side most deposits are on demand or carry floating interest rates and as such their carrying amount is considered a good approximation of their fair value. For longer term, fixed rate deposits the Group calculates the fair value with a duration approach, using the difference in each liability's current interest rate from the rate that a similar deposit would carry today. The fair value estimate of deposits does not take into account the effect of the Payment Service Directive on interest reset dates. All deposits are classified as Level 2 based on the use of observable market interest rates to estimate the fair value.

For the fair value of "Debt issued and other borrowed funds" the Group uses an observed market value where it is available. Issued bonds and bills with quoted market prices are classified as Level 1. If there is no quoted market price the fair value of the debt is valued in the same manner as deposits if it carries a fixed rate. If the debt carries a floating rate its fair value is estimated by comparing the margin with the Group's current funding premium on similar debt. These liabilities are classified as Level 2. The Group estimates its funding premium based on the interest margin on its issued papers including covered bonds, commercial papers as well as foreign currency denominated bonds.

Other financial liabilities mainly include unsettled securities transactions and liabilities to retailers for credit card provisions and are classified as Level 2 since their value is not observable from active market prices. Due to the short-term nature of these liabilities their carrying amount is considered a good approximation of their fair value.

The following tables show the fair value measurement and classification of the Group's assets and liabilities not carried at fair value. The different levels are defined as before (see Note 8):

At 31 December 2016	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Financial assets:					
Cash and balances with Central Bank	-	275,453	-	275,453	275,453
Loans to credit institutions	-	17,645	-	17,645	17,645
Loans to customers	-	-	690,660	690,660	687,840
Other financial assets	-	6,293	-	6,293	6,293
Total financial assets	-	299,391	690,660	990,051	987,231

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Notes to the Consolidated Financial Statements

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At 31 December 2016	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Financial liabilities:					
Deposits from Central Bank and credit institutions	-	4,922	-	4,922	4,922
Deposits from customers	-	594,253	-	594,253	594,187
Debt issued and other borrowed funds	70,907	145,793	-	216,700	212,468
Other financial liabilities	-	36,005	-	36,005	36,005
Total financial liabilities	70,907	780,973	-	851,880	847,582

At 31 December 2015	Level 1	Level 2	Level 3	Total fair value	Carrying amount
Financial assets:					
Cash and balances with Central Bank	-	216,760	-	216,760	216,760
Loans to credit institutions	-	35,534	-	35,534	35,534
Loans to customers	-	-	668,265	668,265	665,711
Other financial assets	-	5,534	-	5,534	5,534
Total financial assets	-	257,828	668,265	926,093	923,539
Financial liabilities:					
Deposits from Central Bank and credit institutions	-	25,631	-	25,631	25,631
Deposits from customers	-	593,402	-	593,402	593,245
Debt issued and other borrowed funds	59,294	91,149	-	150,443	150,308
Subordinated loans	-	19,517	-	19,517	19,517
Other financial liabilities	-	26,642	-	26,642	26,642
Total financial liabilities	59,294	756,341	-	815,635	815,343

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Notes to the Consolidated Financial Statements

Offsetting financial assets and financial liabilities

10. Offsetting financial assets and financial liabilities

The tables below shows reconciliation to the net amounts of financial assets and financial liabilities, which are subject to offsetting, enforceable master netting agreements and similar agreements.

a) Financial assets

	Financial assets subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2016	Gross recognised financial assets before balance sheet netting	Balance sheet netting with gross recognised financial liabilities	Financial assets recognised on the balance sheet, net	Recognised financial liabilities	Cash collateral received	Financial instruments collateral received	Net amount after consideration of potential effect of netting arrangements	Assets outside the scope of offsetting disclosure requirements	Total assets recognised on the balance sheet
Derivatives	1,953	-	1,953	(616)	(402)	(59)	876	-	1,953
At 31 December 2015									
Derivatives	1,981	-	1,981	(696)	(31)	(1)	1,253	-	1,981

b) Financial liabilities

	Financial liabilities subject to netting arrangements			Amounts not set off but subject to master netting arrangements and similar agreements					
At 31 December 2016	Gross recognised financial liabilities before balance sheet netting	Balance sheet netting with gross recognised financial assets	Financial liabilities recognised on the balance sheet, net	Recognised financial assets	Cash collateral pledged	Financial instruments collateral pledged	Net amount after consideration of potential effect of netting arrangements	Liabilities outside the scope of offsetting disclosure requirements	Total liabilities recognised on the balance sheet
Derivative instruments and short positions	4,323	-	4,323	(616)	(297)	-	3,410	475	4,798
At 31 December 2015									
Derivative instruments and short positions	2,908	-	2,908	(696)	-	-	2,212	4,073	6,981

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

Net interest income

11. Net interest income is specified as follows:

	2016	2015
Interest income:		
Cash and balances with Central Bank	11,507	7,394
Loans and receivables	47,084	43,303
Financial assets held for trading	99	980
Financial assets designated at fair value through profit or loss	1,672	1,558
Other assets	141	179
Total interest income	60,503	53,414
Interest expense:		
Deposits from credit institutions and Central Bank	(275)	(517)
Deposits from customers	(20,382)	(18,240)
Borrowings	(7,384)	(5,427)
Subordinated loans	(627)	(1,015)
Other financial liabilities	(7)	(147)
Other interest expense	(26)	(58)
Total interest expense	(28,701)	(25,404)
Net interest income	31,802	28,010
Interest spread (as the ratio of net interest income to the average carrying amount of total assets)	3.1%	2.9%

Net fee and commission income

12. Net fee and commission income is specified as follows:

	2016	2015
Fee and commission income:		
Asset management	1,757	1,778
Investment banking and brokerage	1,987	2,132
Payment processing	14,705	13,664
Loans and guarantees	1,449	1,498
Other fees and commissions income	1,920	1,665
Total fee and commission income	21,818	20,737
Commission expenses:		
Brokerage	(109)	(121)
Clearing and settlement	(7,963)	(7,415)
Other commission expenses	(23)	(31)
Total commission expenses	(8,095)	(7,567)
Net fee and commission income	13,723	13,170

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Net financial income

13. Net financial income is specified as follows:

	2016	2015
Net gain on financial assets and liabilities held for trading	138	1,375
Net (loss) gain on financial assets designated at fair value through profit or loss	(185)	2,506
Net (loss) on fair value hedges	(43)	-
Net gain on financial assets classified as available for sale	6,186	-
Net financial income	6,096	3,881

During the year 2015 the Group's shares in Visa Europe were classified as available for sale financial asset and remeasured to fair value with changes in other comprehensive income to ISK 5,445 million. On 21 June 2016 the Group disposed of its interest in Visa Europe to Visa Inc. and received a mixture of cash and non-cash consideration valued at ISK 6,186 million. The consideration was made up of up-front cash of ISK 4,943 million, of Series C preferred stock in Visa Inc. of ISK 876 million and ISK 367 million deferred cash which will be paid on 21 June 2019. The preferred shares may be reduced by any final settlement of potential liabilities relating to ongoing inter charge related litigation involving Visa Europe. At the completion of the sale of the shares in Visa Europe, an increase in value in 2016 of ISK 741 million was recognised in other comprehensive income and the total of increase in value in 2015 and 2016 of ISK 6,186 million reclassified to profit and loss. The preferred shares in Visa Inc. are classified as available for sale asset with estimated value of ISK 819 million as of 31 December 2016.

Net gain on financial assets and liabilities held for trading

14. Net gain on financial assets and liabilities held for trading is specified as follows:

	2016	2015
Shares and related derivatives	(182)	487
Dividend income on shares held for trading	90	105
Bonds and related derivatives	(62)	530
Other derivatives	292	253
Net gain on financial assets and liabilities held for trading	138	1,375

Net (loss) gain on financial assets designated at fair value through profit or loss

15. Net (loss) gain on financial assets designated at fair value through profit or loss is specified as follows:

	2016	2015
Shares	(368)	2,324
Bonds	183	182
Net (loss) gain on financial assets designated at fair value through profit or loss	(185)	2,506

Net (loss) on fair value hedges

16. Net (loss) on fair value hedges is specified as follows:

	2016	2015
Clean fair value (loss) on interest rate swaps designated as hedging instruments	(335)	-
Fair value gain on bonds issued by the Group attributable to interest rate risk	292	-
Net (loss) on fair value hedges	(43)	-

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Net foreign exchange gain (loss)

17. Net foreign exchange gain (loss) is specified as follows:

	2016	2015
Assets:		
Cash and balances with Central Bank	(303)	(136)
Financial assets held for trading	(8,735)	(4,315)
Financial assets designated at fair value through profit or loss	(205)	(24)
Loans and receivables	(23,759)	(6,255)
Other assets	(681)	113
Total assets	(33,683)	(10,617)
Liabilities:		
Deposits	14,461	4,705
Subordinated loans	1,697	1,787
Debt issued and other borrowed funds	17,305	2,918
Other liabilities	663	(283)
Total liabilities	34,126	9,127
Net foreign exchange gain (loss)	443	(1,490)

Other operating income

18. Other operating income is specified as follows:

	2016	2015
Share of profit of associates net of income tax	48	63
Net (loss) in associates	(170)	-
Service level agreement fees	77	194
Legal cost and fees	135	171
Rental income	58	285
Gain from sale of buildings	363	23
Other net operating income	141	366
Other operating income	652	1,102

Personnel and salaries

19. Salaries and related expenses are specified as follows:

	2016	2015
Salaries	11,821	10,868
Pension and similar expenses	1,682	1,585
Social security charges and financial activities tax*	1,552	1,507
Other	302	205
Capitalisation of internal staff costs in software development	(568)	(274)
Salaries and related expenses	14,789	13,891

*Financial activities tax calculated on salaries 5.5% (2015: 5.5%).

The Group made a provision of ISK 430 million (2015: ISK 378 million) for potential performance plan payments. In accordance with the FME rules no. 700/2011, part of the payment is deferred for a minimum of 3 years. Salary related expenses are included in the amount.

The performance based salaries are based on FME rules no. 700/2011 on remuneration policy for financial undertakings. The rules reflect a conservative framework for remuneration schemes within the financial sector. The remuneration policy shall not encourage unreasonable risk taking, nor contravene the long-term interests of the undertaking and the stability of the financial system.

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20. The Group's total number of employees is as follows:

	2016		2015	
	The Bank	The Group	The Bank	The Group
Average number of employees	955	1,161	958	1,222
Positions at the end of the year	910	1,075	919	1,184

Average number of employees for the Group in 2016 includes 42 employees (2015: 108 employees) in disposal groups held for sale, whose salaries are not included in the salaries and related expenses.

21. Total amount of compensation to the Board of Directors, the CEO and Management Board are specified as follows:

	Salaries	
	2016	2015
Fridrik Sophusson, Chairman of the Board	9.3	9.0
Helga Valfells, Vice-Chairman of the Board	6.7	6.2
Anna Thórdardóttir, member of the Board	4.8	-
Audur Finnbogadóttir, member of the Board	4.4	-
Árni Stefánsson, member of the Board	4.4	-
Hallgrímur Snorrason, member of the Board	4.4	-
Heidrún Jónsdóttir, member of the Board	4.4	-
Marianne Økland, former Vice-Chairman of the Board	2.3	6.6
Árni Tómasson, former member of the Board	2.1	6.2
Eva Cederbalk, former member of the Board	2.3	5.2
Gunnar Fjalar Helgason, former member of the Board	1.6	1.2
Neil Graeme Brown, former member of the Board	2.3	6.6
John E. Mack, former Vice-Chairman of the Board	-	1.6
Thóranna Jónsdóttir, former member of the Board	-	4.5
Alternate board members	1.6	0.2
Total	50.6	47.2

	2016		2015	
	Salaries	Performance based payments*	Salaries	Performance based payments*
Birna Einarsdóttir, CEO	49.1	9.1	43.7	7.2
8 Managing Directors	232.3	39.8	221.3	29.1

*According to the FME rules on variable remuneration, the aggregate of variable remuneration including deferred payments shall not amount to more than 25% of the annual salary of the person in question, exclusive of variable remuneration. Payment of at least 40% of the variable remuneration shall be deferred for a minimum of three years. If the employee gives a notice of termination, the employee shall no longer be entitled to the deferred payment. In 2015 a deferred payment was paid out for the first time, 40% remainder from 2011.

The employer's contribution to pension funds and other benefits for the Board, CEO and Management Board amounted to ISK 72.9 million in 2016 (2015: ISK 68.9 million). There were no share based payments in the years 2016 and 2015.

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Other operating expenses

22. Other operating expenses are specified as follows:

	2016	2015
Professional services	4,425	4,117
Real estate and fixtures	3,555	2,795
Depreciation and amortisation	2,072	808
Other administrative expenses	2,280	2,149
Other operating expenses	12,332	9,869

Auditors' fees

23. Auditors' fees are specified as follows:

	2016	2015
Audit of the annual accounts	101	113
Review of interim accounts	22	29
Other services	17	43
Auditors' fees	140	185

Net loan impairment

24. Net loan impairment is specified as follows:

	2016	2015
Specific impairment	(1,090)	(3,567)
Collective impairment	310	383
Impairment reversal due to revised estimated future cash flows	1,515	11,319
Net loan impairment	735	8,135

Profit from discontinued operations

25. Profit from discontinued operations are specified as follows:

	2016	2015
Net profit from sale of foreclosed mortgages	748	646
Net share of profit from disposal groups held for sale	1,599	653
Net profit from sale of subsidiaries and associates	592	27
Profit from discontinued operations, net of income tax	2,939	1,326

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Income taxes

26. Income tax is recognised based on applicable tax rates and tax laws, the income tax rate for legal entities in 2016 was 20% (2015: 20%). Special financial activities tax is calculated as 6% of taxable profits exceeding ISK 1 billion in accordance with Act. no 165/2011 Financial Activities Tax. The effective income tax rate in the Group's income statement for 2016 is 23.2% (2015: 23.3%).

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

	2016	2015
Current tax expense	3,897	4,027
Special financial activities tax	1,060	1,046
Difference in prior year's imposed and calculated income tax	57	(34)
Origination and reversal of temporary differences due to deferred tax assets/liabilities	191	812
Total	5,205	5,851

The effective income tax rate is specified as follows:

	2016		2015	
Profit before tax	22,424		25,103	
20% income tax calculated on the profit of the year	4,485	20.0%	5,021	20.0%
Special financial activities tax	1,060	4.7%	1,046	4.2%
Income not subject to tax	(1,132)	(5.0%)	(820)	(3.3%)
Non-deductable expenses	579	2.6%	565	2.2%
Other differences	213	0.9%	39	0.2%
Income tax expense	5,205	23.2%	5,851	23.3%

The Banki is taxed jointly with its subsidiary Íslandssjódir hf.

Earnings per share

27. Earnings per share are specified as follows:

	Discontinued operations			
	Excluded		Included	
	2016	2015	2016	2015
Net profit to the equity holders of the parent, according to the consolidated income statement	14,008	18,674	16,947	20,000
Weighted average number of outstanding shares for the period, million	10,000	10,000	10,000	10,000
Basic earnings per share	1.40	1.87	1.69	2.00

There were no instruments at the end of the year that could potentially dilute basic earnings per share (2015: none).

Cash and balances with Central Bank

28. Specification of cash and balances with Central Bank:

	31.12.2016	31.12.2015
Cash on hand	3,073	2,784
Balances with Central Bank other than mandatory reserve deposits	26,526	15,458
Term deposits	198,661	183,539
Balances with Central Bank assets subject to special restrictions*	34,532	-
Included in cash and cash equivalents	262,792	201,781
Mandatory reserve deposits with Central Bank	12,661	14,979
Cash and balances with Central Bank	275,453	216,760

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

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Derivative instruments and short positions

29. Derivative instruments and short positions are specified as follows:

At 31 December 2016

	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	762	58,055	1,991	123,333
Cross currency interest rate swaps	782	8,293	765	24,989
Equity forwards	237	2,494	152	2,141
Foreign exchange forwards	30	2,660	1,056	13,992
Foreign exchange swaps	141	13,128	231	21,105
Bond forwards	1	400	26	3,610
Bond options	-	-	102	25,000
Derivatives	1,953	85,030	4,323	214,170
Short positions in listed bonds	-	-	475	-
Total	1,953	85,030	4,798	214,170

At 31 December 2015

	Assets	Notional values related to assets	Liabilities	Notional values related to liabilities
Interest rate swaps	533	13,687	1,435	37,340
Cross currency interest rate swaps	1,138	26,212	148	10,209
Equity forwards	56	1,283	588	3,003
Foreign exchange forwards	21	1,551	391	7,687
Foreign exchange swaps	82	9,918	236	17,034
Bond forwards	151	3,015	14	920
Bond options	-	-	96	25,000
Derivatives	1,981	55,666	2,908	101,193
Short positions in listed bonds	-	-	4,073	-
Total	1,981	55,666	6,981	101,193

The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. The Group carries relatively low indirect exposure due to margin trading with clients and the Group holds collaterals for possible losses. Other derivatives in the Group held for trading or for other purposes are insignificant.

Short positions are in Icelandic government bonds and institutions with government guarantees. As a primary dealer the Group has access to securities lending facilities provided by the Central Bank and the Housing Financing Fund. Majority of the securities lending facilities have a maturity of less than a year.

The Group applies hedge accounting only with respect to certain euro denominated interest rate swaps, whereby the Group pays floating rate interest and receives fixed rate interest. The interest rate swaps are hedging the exposure of changes in the fair value of certain fixed-rate euro denominated bonds (see Note 46) arising from changes in interest rates. The Group started to apply hedge accounting in the course of the fourth quarter 2016. The Group applies fair value hedge accounting to the hedging relationships. The total fair value of the interest rate swaps at year-end 2016 was negative and amounted to ISK 385 million. Their total notional values at year-end 2016 amounted to ISK 59,565 million.

AMOUNTS ARE IN ISK MILLION

Loans and receivables

30. Loans to credit institutions are specified as follows:

	31.12.2016	31.12.2015
Money market loans	5,642	3,888
Bank accounts	12,003	31,646
Loans to credit institutions	17,645	35,534

31. Loans to customers - impairment allowance per sector:

At 31 December 2016

	Gross amount	Specific impairment allowance	Loans less impairment allowance
Loans to customers:			
Individuals	288,455	(2,278)	286,177
Commerce and services	99,010	(1,067)	97,943
Construction	29,644	(1,766)	27,878
Energy	7,216	-	7,216
Financial services	85	-	85
Industrial and transportation	67,391	(4,301)	63,090
Investment companies	15,289	(887)	14,402
Public sector and non-profit organisations	12,848	(13)	12,835
Real estate	100,751	(731)	100,020
Seafood	80,672	(429)	80,243
Loans to customers before collective impairment allowance			689,889
Collective impairment allowance			(2,049)
Loans to customers	701,361	(11,472)	687,840

At 31 December 2015

	Gross amount	Specific impairment allowance	Loans less impairment allowance
Loans to customers:			
Individuals	276,053	(3,443)	272,610
Commerce and services	90,956	(1,175)	89,781
Construction	24,815	(1,802)	23,013
Energy	3,737	-	3,737
Financial services	105	-	105
Industrial and transportation	63,589	(2,863)	60,726
Investment companies	21,643	(2,281)	19,362
Public sector and non-profit organisations	13,878	-	13,878
Real estate	99,869	(775)	99,094
Seafood	86,938	(1,066)	85,872
Loans to customers before collective impairment allowance			668,178
Collective impairment allowance			(2,467)
Loans to customers	681,583	(13,405)	665,711

AMOUNTS ARE IN ISK MILLION ÍSLANDSBANKI HF. | CONSOLIDATED FINANCIAL STATEMENTS 2016 37

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32. Impairment

The following table shows the movement in the provision for impairment losses for loans:

	Specific impairment allowance	Collective impairment allowance	Total
At 1 January 2016	13,405	2,467	15,873
Amounts written-off	(3,799)	-	(3,799)
Recoveries of amounts previously written-off	711	-	711
Charged to the income statement	1,090	(310)	780
Other	65	(108)	(43)
At 31 December 2016	11,472	2,049	13,521

	Specific impairment allowance	Collective impairment allowance	Total
At 1 January 2015	16,908	2,851	19,759
Amounts written-off	(6,699)	-	(6,699)
Recoveries of amounts previously written-off	591	-	591
Principal credit adjustment	(461)	-	(461)
Charged to the income statement	3,567	(383)	3,184
Other	(501)	-	(501)
At 31 December 2015	13,405	2,467	15,873

Investments in associates

33. Changes in investments in associates:

	2016	2015
Investments in associates at the beginning of the year	716	570
Additions during the period	104	33
Sales of shares in associates	(248)	-
Share of results	48	63
Dividends paid	-	23
Impairment	(170)	-
Other	-	27
Investments in associates	450	716

34. The Group's interest in its associates are as follows:

	Location	Ownership 31.12.2016	Ownership 31.12.2015
Atorka Group hf., a holding company, Sudurlandsbraut 18, 108 Reykjavík	Iceland	-	26.8%
Audkenni hf., an information security company, Borgartúni 31, 105 Reykjavík	Iceland	23.8%	22.4%
B-Payment Szolgáltató Zrt, an electronic payment processing company, H-1132 Budapest	Hungary	35.0%	-
FAST GP ehf., a holding company, Katrínartúni 2, 105 Reykjavík	Iceland	35.0%	35.0%
Reiknistofa bankanna hf., an IT service centre company, Katrínartúni 2, 105 Reykjavík	Iceland	30.8%	30.8%
Summa Rekstrarfélag hf., an investment fund company, Tjarnargötu 4, 101 Reykjavík*	Iceland	25.0%	-

*At year-end 2015 Summa Rekstrarfélag hf. was a subsidiary of the Bank.

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34. Cont'd

Summarised financial information in respect of the Group's associates is set out below:

	31.12.2016	31.12.2015
Total assets	5,021	5,172
Total liabilities	(2,690)	(2,284)
Net assets	2,331	2,888
Group's share of net assets of associates	450	716

	2016	2015
Total revenue	5,015	4,605
Total profit (loss) of associates for the year	313	(613)

Investment in subsidiaries

35. Significant subsidiaries:

	Location	Ownership	
		31.12.2016	31.12.2015
Borgun hf., a payment acquirer and issuing processor, Ármúla 30, 108 Reykjavík	Iceland	63.5%	63.5%
Íslandssjódir hf., an investment fund management company, Kirkjusandi 2, 105 Reykjavík	Iceland	100%	100%
IS Thróunarsjódurinn Langbrók, a professional investment fund, Kirkjusandi 2, 105 Reykjavík	Iceland	100%	-
Hringur eignarhaldsfélag ehf., a holding company, Digranesvegi 1, 200 Kópavogur	Iceland	100%	100%
Allianz Ísland hf., an insurance agent, Digranesvegi 1, 200 Kópavogur	Iceland	100%	100%
D-1 ehf., a commercial real estate company, Kirkjusandi 2, 105 Reykjavík	Iceland	100%	100%

Other non-significant subsidiaries:
In addition Íslandsbanki has control over 18 other subsidiaries.

36. Non-controlling interests in subsidiaries

Borgun hf. is the only significant subsidiary of Íslandsbanki that has a material non-contolling interest (2016: 36.5%, 2015: 36.5%).

The following table summarises key information relevant to Borgun hf.:

	2016	2015
Loans and receivables	4,272	4,329
Other assets	33,922	31,411
Liabilities	27,469	25,206
Net assets	10,725	10,534
Carrying amount of non-controlling interests	3,915	3,845
Revenue	11,448	4,674
Profit	7,866	1,523
Other comprehensive income for the year, net of tax	(5,484)	5,445
Total comprehensive income	2,382	6,968
Profit allocated to non-controlling interests	869	2,543
Cash flows from operating activities	3,498	1,490
Cash flows from investing activities	4,724	(574)
Cash flows from financing activities	(2,187)	(800)
Net increase in cash and cash equivalents	6,035	116

Borgun paid out ISK 2,187 million in dividends to its shareholders in the year 2016.

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Related party disclosures

37. Related party disclosures

Íslandsbanki is wholly owned by the Icelandic Government, directly and through ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by the Icelandic State Financial Investments ("ISFI"). As a result, the Icelandic Government and the Icelandic State Financial Investments, and the members of the Board of Directors of ISFI are defined as related parties of the Group. The Group has applied the partial exemption for government-related entities as described in IAS 24 paragraphs 25-27.

The Board of Directors of the parent company, the key management personnel, close family members of individuals referred to herein and legal entities controlled by them, are defined as related parties.

The Group's associates, and their key management personnel and legal entities controlled by them, are also defined as related parties.

Related party transactions

The Group's products and services are offered to the Icelandic Government and government-related entities in competition with other vendors and under generally accepted commercial terms. In a similar manner, the Bank and other Group entities purchase products and services from government-related entities at market price and otherwise under generally accepted commercial terms.

Cash and balances with the Central Bank are disclosed under Note 28 and Deposits from the Central Bank are disclosed under Note 42.

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

At 31 December 2016

Balance with related parties:	Assets	Liabilities	Net balance	Guarantees	Commitments and overdraft
Shareholders with control over the Group	-	(101)	(101)	-	1
Board of Directors and key management personnel	335	(606)	(271)	-	72
Associated companies and other related parties	523	(1,065)	(542)	1	227
Balance with related parties	858	(1,772)	(914)	1	300

Transactions with related parties:	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(4)	-	-
Board of Directors and key management personnel	33	(24)	4	-
Associated companies and other related parties	34	(32)	8	-
Transactions with related parties	67	(60)	12	-

At 31 December 2015

Balance with related parties:	Assets	Liabilities	Net balance	Guarantees	Commitments and overdraft
Shareholders with control over the Group	-	(110)	(110)	-	-
Board of Directors and key management personnel	359	(563)	(204)	-	67
Associated companies and other related parties	533	(479)	54	-	228
Balance with related parties	892	(1,152)	(260)	-	295

Transactions with related parties:	Interest income	Interest expense	Other income	Other expense
Shareholders with control over the Group	-	(4)	-	-
Board of Directors and key management personnel	22	(18)	3	-
Associated companies and other related parties	37	(37)	43	-
Transactions with related parties	59	(59)	46	-

Impairment allowances of ISK -1 million (2015: ISK -1 million) were recognised during the year against balances outstanding with associated companies. No share option programmes were operated during 2016. For related party remuneration see Note 21.

AMOUNTS ARE IN ISK MILLION

Property and equipment

38. Property and equipment are specified as follows:

At 31 December 2016	Land and buildings	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	6,787	4,883	11,670
Additions during the year	119	1,151	1,270
Disposals and write-offs during the year	(1,611)	(1,174)	(2,785)
Balance at 31.12.2016	5,295	4,860	10,155
Accumulated depreciation			
Balance at the beginning of the year	(1,539)	(2,787)	(4,326)
Depreciation during the year	(83)	(591)	(674)
Impairment during the year	(768)	-	(768)
Disposals and write-offs during the year	1,134	690	1,824
Balance at 31.12.2016	(1,256)	(2,688)	(3,944)
Carrying amount at 31.12.2016	4,039	2,172	6,211
Depreciation rates	0-2%	8-33%	

Official real estate value of buildings and land	4,254
Insurance value of buildings as at 31.12.2016	5,328
Insurance value of fixtures, equipment and vehicles as at 31.12.2016	2,724

During the year a mould problem was discovered at the Bank's headquarters at Kirkjusandur. The future of the building has not been determined. At the end of 2016, the Bank moved its headquarters to a new building in Kópavogur. The relocation will be finalised in the first half of 2017. Some of the fixtures at Kirkjusandur had to be disposed of.

At 31 December 2015	Land and buildings	Fixtures, equipment & vehicles	Total
Historical cost			
Balance at the beginning of the year	6,753	4,533	11,286
Additions during the year	169	574	743
Disposals and write-offs during the year	(135)	(224)	(359)
Balance at 31.12.2015	6,787	4,883	11,670
Accumulated depreciation			
Balance at the beginning of the year	(1,440)	(2,444)	(3,884)
Depreciation during the year	(109)	(507)	(616)
Disposals and write-offs during the year	10	164	174
Balance at 31.12.2015	(1,539)	(2,787)	(4,326)
Carrying amount at 31.12.2015	5,248	2,096	7,344
Depreciation rates	0-2%	8-33%	

Official real estate value of buildings and land	4,076
Insurance value of buildings as at 31.12.2015	5,929
Insurance value of fixtures, equipment and vehicles as at 31.12.2015	2,261

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Intangible assets

39. Intangible assets are specified as follows:

At 31 December 2016	Purchased software	Developed software	Total
Historical cost			
Balance at the beginning of the year	1,514	476	1,990
Additions during the year and internal development	195	1,298	1,493
Disposals during the year	(111)	-	(111)
Balance at 31.12.2016	1,598	1,774	3,372
Accumulated amortisation			
Balance at the beginning of the year	(458)	(201)	(659)
Amortisation during the year	(120)	-	(120)
Disposals during the year	79	-	79
Balance at 31.12.2016	(499)	(201)	(700)
Carrying amount at 31.12.2016	1,099	1,573	2,672
Amortisation rates	25%	10-25%	

At 31 December 2015	Purchased software	Developed software	Total
Historical cost			
Balance at the beginning of the year	940	202	1,142
Additions during the year and internal development	574	274	848
Balance at 31.12.2015	1,514	476	1,990
Accumulated amortisation			
Balance at the beginning of the year	(340)	(183)	(523)
Amortisation during the year	(118)	(18)	(136)
Balance at 31.12.2015	(458)	(201)	(659)
Carrying amount at 31.12.2015	1,056	275	1,331
Amortisation rates	25%	25%	

Other assets

40. Other assets are specified as follows:

	31.12.2016	31.12.2015
Receivables	5,090	4,166
Unsettled securities transactions	652	1,279
Accruals	749	616
Prepaid expenses	300	265
Deferred tax assets	4	21
Other assets	269	327
Other assets	7,064	6,674

AMOUNTS ARE IN ISK MILLION

Non-current assets and disposal groups held for sale

41. Specification of non-current assets and disposal groups held for sale:

	31.12.2016	31.12.2015
Repossessed collateral	3,348	5,471
Assets of disposal groups classified as held for sale	3,036	7,321
Total	6,384	12,792

Repossessed collateral:

	31.12.2016	31.12.2015
Land and property	3,319	5,427
Industrial equipment and vehicles	29	44
Total	3,348	5,471

At year end the Group classified the assets and liabilities of the following subsidiaries as assets and liabilities of disposal groups held for sale: Fastengi ehf. (100%), IG Invest ehf. (71.1%), LT lódir ehf. (100%), Geysir Green Investment Fund slhf. (100%), ÍSB fasteignir ehf. (100%) and Fergin ehf. (80%).

The income tax expense for discontinued operation amounted to ISK 286 million in the year 2016.

Assets of disposal groups classified as held for sale:

	31.12.2016	31.12.2015
Cash	1,545	592
Equity instruments	775	775
Receivables	36	1,378
Property and land	633	2,044
Other assets	47	2,532
Total	3,036	7,321

Liabilities associated with assets and disposal groups classified as held for sale:

	31.12.2016	31.12.2015
Payables	52	77
Tax liabilities	269	325
Borrowings	-	2,299
Other liabilities	4	124
Total	325	2,825

At the end of June 2016 the Group sold 80% of its shareholding in Frumherji hf. In October 2016 the Group sold 100% of its shareholding in Gráhella ehf. The entities were classified as disposal groups held for sale.

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Deposits from Central Bank and credit institutions

42. Deposits from Central Bank and credit institutions are specified as follows:

	31.12.2016	31.12.2015
Repurchase agreements with Central Bank	70	97
Deposits from credit institutions	4,852	25,534
Deposits from Central Bank and credit institutions	4,922	25,631

Deposits from customers

43. Deposits from customers are specified by type as follows:

	31.12.2016	31.12.2015
Demand deposits	501,045	485,128
Time deposits	93,142	108,117
Deposits from customers	594,187	593,245

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

44. Deposits from customers are specified by owners as follows:

	31.12.2016		31.12.2015	
	Amount	% of total	Amount	% of total
Central government and state-owned enterprises	10,264	2%	9,274	2%
Municipalities	5,277	1%	4,598	1%
Companies	335,766	56%	364,651	61%
Individuals	242,880	41%	214,722	36%
Deposits from customers	594,187	100%	593,245	100%

Pledged assets

45. Pledged assets against liabilities:

	31.12.2016	31.12.2015
Financial assets which have been pledged as collateral against liabilities	119,277	108,265
Financial assets which have been pledged as collateral in foreign banks	457	578
Pledged assets against liabilities	119,734	108,843

The Group has pledged assetes against the issuance of covered bonds under Icelandic law, with maturities of up to 10 years, which are mainly pledged on a pool of consumer mortgage loans. The underlying cover pool must withstand a weekly stress test with regards to interest rates and exchange rates. The Group also pledged a pool of consumer mortgage loans as collateral for an asset-backed bond originally issued to the Central Bank.

The Group has also pledged cash in foreign banks and financial institutions, mainly as collateral for trades under ISDA agreements to hedge market risk. The comparative number in the line item "Financial assets which have been pledged as collateral against liabilities" at 31.12.2015 has been increased by ISK 400 million for comparison with 2016 to take into consideration a pledged cash account for the covered bonds.

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Debt issued and other borrowed funds

46. Specification of debt issued and other borrowed funds:

	Issued	Maturity	Maturity type	Terms of interest	31.12.2016	31.12.2015
Covered bond in ISK	2013-2014	2016	At maturity	Fixed, 6.2523%	-	2,852
Covered bond in ISK	2014-2016	2019	At maturity	Fixed, 6.9299%	8,024	4,158
Covered bond in ISK	2015	2023	At maturity	Fixed 6.40%	7,467	5,559
Covered bond in ISK - CPI-linked	2011	2016	At maturity	Fixed, CPI-linked, 3.50%	-	4,421
Covered bond in ISK - CPI-linked	2012-2014	2019	At maturity	Fixed, CPI-linked, 2.84%	8,528	8,362
Covered bond in ISK - CPI-linked	2014-2015	2020	At maturity	Fixed, CPI-linked, 3.4699%	4,049	3,968
Covered bond in ISK - CPI-linked	2015-2016	2022	At maturity	Fixed, CPI-linked, 2.98%	5,461	2,836
Covered bond in ISK - CPI-linked	2012-2015	2024	At maturity	Fixed, CPI-linked, 3.45%	11,317	11,113
Covered bond in ISK - CPI-linked	2015-2016	2026	At maturity	Fixed, CPI-linked, 3.372%	19,379	6,408
Covered bonds					64,225	49,677
Senior unsecured bond in SEK	2013-2014	2017	At maturity	Floating, STIBOR + 4.00%	9,971	12,359
Senior unsecured bond in EUR	2014	2016	At maturity	Fixed, 3.00%	-	7,449
Senior unsecured bond in EUR*	2016	2020	At maturity	Fixed, 1.75%	61,125	-
Senior unsecured bond in SEK	2015	2019	At maturity	Floating, STIBOR + 3.10%	7,493	9,280
Senior unsecured bond in EUR	2015-2016	2018	At maturity	Fixed, 2.875%	36,140	32,018
Senior unsecured bond in NOK	2015	2018	At maturity	Floating, NIBOR + 2.60%	6,566	7,365
Senior unsecured bond in USD	2016	2017	At maturity	Floating, LIBOR + 1.70%	3,963	-
Bonds issued					125,258	68,471
Loans from credit institutions					14,773	2
Central Bank secured bond in ISK					-	19,732
Bills issued					5,755	9,992
Other debt securities					2,457	2,434
Other loans / bills					22,985	32,160
Debt issued and other borrowed funds					212,468	150,308

*The Group applies hedge accounting to this bond issuance and uses certain euro denominated interest rate swaps as hedging instruments (see Note 29). The interest rate swaps are hedging the exposure of the Group's changes in the fair value of this fixed-rate euro denominated bond arising from changes in interest rates. The Group started to apply hedge accounting in the course of the fourth quarter 2016. The Group applies fair value hedge accounting to the hedging relationships. The total carrying amount of the bond issuance is ISK 61,125 million and included in the amount are fair value changes amounted to ISK 292 million (see Note 16).

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

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

Subordinated loans

47. Specification of subordinated loans:

	Issued	Currency	Book value 31.12.2016	Book value 31.12.2015
Loans which qualify as Tier 2 capital:				
Subordinated loans - unlisted	2009	EUR	-	19,517
Subordinated loans			-	19,517

Within subordinated loans was a Tier 2 bond of EUR 138 million, which was paid up in the third quarter of 2016.

In 2016 the interest rate was 4.714% (2015: 4.96%).

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Tax assets and tax liabilities

48. Tax in the balance sheet:

	31.12.2016		31.12.2015	
	Assets	Liabilities	Assets	Liabilities
Current tax	-	7,986	-	8,045
Deferred tax	4	487	21	313
Tax in the balance sheet	4	8,473	21	8,358

49. Changes in the deferred tax assets and the tax liabilities during the year were as follows:

	Assets	Liabilities
Deferred tax assets and tax liabilities 1.1.2015	521	2
Transferred deferred tax liabilities to deferred tax assets 1.1.2015	(507)	(507)
Calculated income tax for 2015	(401)	4,456
Income tax payable in 2016	408	(3,753)
Prior year income tax adjustment	-	115
Deferred tax assets and tax liabilities 31.12.2015	21	313
Transferred deferred tax assets to deferred tax liabilities 1.1.2016	(22)	(22)
Calculated income tax for 2016	(22)	4,264
Income tax payable in 2017	27	(4,049)
Prior year income tax adjustment	-	(19)
Deferred tax assets and tax liabilities 31.12.2016	4	487

50. Movements in temporary differences during the year were as follows:

2016	Net balance at 1 January	Recognised in profit or (loss)	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(197)	50	(147)	-	(147)
Assets and liabilities denominated in foreign currency	(218)	35	(183)	-	(183)
Other intangible assets	(81)	(94)	(175)	-	(175)
Deferred foreign exchange difference	205	(182)	23	23	-
Tax loss carry forwards	(1)	-	(1)	-	(1)
	(292)	(191)	(483)	23	(506)
Set-off of deferred tax assets together with liabilities of the same taxable entities				(19)	19
Tax assets (liabilities)	(292)	(191)	(483)	4	(487)

2015	Net balance at 1 January	Recognised in profit or (loss)	Balance at 31 December Net	Deferred tax assets	Deferred tax liabilities
Property and equipment	(204)	7	(197)	19	(216)
Assets and liabilities denominated in foreign currency	(187)	(31)	(218)	-	(218)
Other intangible assets	693	(774)	(81)	-	(81)
Deferred foreign exchange difference	217	(12)	205	205	-
Tax loss carry forwards	-	(1)	(1)	-	(1)
	519	(811)	(292)	224	(516)
Set-off of deferred tax assets together with liabilities of the same taxable entities				(203)	203
Tax assets (liabilities)	519	(811)	(292)	21	(313)

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Other liabilities

51. Specification of other liabilities:

	31.12.2016	31.12.2015
Accruals	4,219	3,632
Liabilities to retailers for credit cards	25,494	23,869
Provision for effects of court rulings*	1,344	1,665
Provision for estimated losses from guarantees and others**	86	207
Withholding tax	7,165	2,072
Unsettled securities transactions	1,551	1,698
Deferred income	190	130
Sundry liabilities	3,407	3,404
Other liabilities	43,456	36,677

Provision:	Provision for effects of court rulings*	Provision for estimated losses from guarantees and others**	Total
At 1 January 2016	1,665	207	1,872
New provision and reversed provision during the year	(321)	(121)	(442)
At 31 December 2016	1,344	86	1,430

Equity

52. Share capital

Authorised share capital of the Group is 10,000 million ordinary shares of ISK 1 each. At 31.12.2016 paid up share capital totalled ISK 65,000 million which is the total stated share capital of the Group. The Group has one class of ordinary shares which carry no right to fixed income.

In June 2016 the Icelandic Parliament approved amendments to the Act on Annual Accounts no. 3/2006 including new requirements on equity reserves that may affect future dividend payments. For further information see Note 86.19.

Total share capital:	31.12.2016	31.12.2015
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Total share capital	65,000	65,000

53. Other reserves are specified as follows:

	Other reserves
Other reserves as at 1.1.2015	2,535
Translation differences	9
Other reserves as at 31.12.2015	2,544
Translation differences	(52)
Restricted due to capitalised development cost	1,302
Restricted due to fair value changes	113
Restricted due to subsidiaries and associated companies	257
Other reserves as at 31.12.2016	4,164

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Operating lease commitments

54. Future non-cancellable minimum operating lease payments, where the Group is the lessee, are due as follows:

	31.12.2016	31.12.2015
Up to 1 year	529	240
1-5 years	2,002	661
Later than 5 years	4,123	391
Operating lease commitments	6,654	1,292

The Group leases a few branch and office premises under operating leases. The typical lease period is 5-20 years with a continuation clause. In some leases the rent is based on the consumer price index and changes accordingly.

At the end of 2016 the Bank moved its headquarters to a new building in Kópavogur, this results in an increase in operating lease commitments. The relocation will be finalised in the first half of 2017.

Custody assets

55. Custody assets:

	31.12.2016	31.12.2015
Custody assets	1,216,155	665,046

Custody assets are under custody, but not managed by the Group.

Contingencies

56. Contingencies

Provisions

Foreign currency-linked loan contracts

The few remaining foreign currency-linked loan contracts court cases concern minor deviations in contract terms from those previously found to be legal contracts. The District Courts have ruled in favour of the Group in the majority of these cases. The Supreme Court is expected to rule on most of them during the next 12 to 16 months. However, as some of the cases involve more or less similar contracts, a precedent could result in other cases being settled out of court. The most recent favourable Supreme Court ruling (14 April 2016), involved by far the largest single contract. Some similar District Court rulings have been passed since then. The Group considers the rest of the court cases will not leave much impact even if some of those contracts in question are found to be faulty.

Recent adverse rulings against Landsbankinn in three cases involving foreign currency-linked loan contracts are unlikely to affect the Group seeing that the remaining cases are based on a different criteria.

Total provision of ISK 1,344 million (see Note 51) has been recognised in the Group's Consolidated Financial Statements as at 31 December 2016 due to the aforementioned loan contracts.

Contingent liabilities

Variable rate loan contracts

In September 2014, the Consumer Appellate Committee (the “Committee”) published its decision on a matter regarding the terms of, and information relating to the granting of, a consumer mortgage contract with interest reset terms granted by the Group in 2005. The Committee confirmed the opinion of the Consumer Agency which found the terms offered by the Group and its predecessors, regarding the method and conditions of resetting interest rates, to be in breach of Articles 6 and 9 of Act no. 121/1994 on Consumer Credit (superseded in November 2013). The Committee found the terms to be insufficient as to the explanation of how or what can affect the decision for the interest rate being revised. A 2009 Committee decision was quoted as a precedent. Subsequent to the Consumer Agency's decision, the Group decided to postpone a scheduled interest rate reset and customers were given the option to have their loans restructured with appropriate documentation, fully adapted to the new law on consumer credit.

The Group referred the matter to the courts. The District Court acquitted the Group. The consequences of an adverse outcome in the Supreme Court is not easily quantifiable. At present, the Group has not recognised any provision against a possible loss due to this litigation. In part this is due to the fact that early payments and refinancing is rapidly decreasing the number of contracts in question. Thus, a sufficiently reliable estimate of the amount of the obligation cannot be made.

AMOUNTS ARE IN ISK MILLION

Notes to the Consolidated Financial Statements

56. Cont'd

Formal investigation by the Icelandic Competition Authority regarding an alleged violation of competition law

In 2013 the Icelandic Competition Authority ("ICA") initiated an investigation concerning alleged violations of the Competition Law no. 44/2005 by the Group. Details of the investigation remain confidential.

The ICA has requested and received information from the Group and has, following its review, presented an opposition document. The ICA considers the violations to be extensive, to have been in existence for a considerable period and to concern important markets. The opposition document is one stage in the processing of the case and does not comprise a final administrative decision.

The Group strongly disagrees with the ICA's findings and has presented its objections. However, should the ICA's findings be final, sanctions may come into consideration, in accordance with Article 37 of the Competition Act. As the result of the case or the amounts involved cannot be estimated, the Group has not recognised a provision in relation to this matter.

Borgun hf.

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

Landsbankinn hf. (the plaintiff) is asking the court to affirm the joint liability of Borgun hf., BPS ehf., Eignarhaldsfélagið Borgun slf. and Mr. Haukur Oddsson, CEO of Borgun to pay damages for the plaintiff's alleged loss resulting from the defendant's negligence to inform the plaintiff of the value of Borgun's share in Visa Europe Ltd. The defendants have denied liability and stated that they will defend against the plaintiff's claims. The plaintiff does not define its claim in the case. The plaintiff does however state that he estimates having foregone a profit of approximately ISK 1,930 million by selling its shares in Borgun. As the results of the case and the financial affect cannot be estimated, the Group has not recognised a provision in relation to this matter.

Kortaþjónustan hf.

Kortaþjónustan hf. filed suit against Íslandsbanki hf., Arion banki hf., Landsbankinn hf., Borgun hf. and Valitor hf. on 27 June 2013. The plaintiff is asking that the defendants pay damages (in solidum) in the amount of ISK 1,200 million, plus interest, mainly due to alleged infringements of competition law. The Bank has put forward its arguments in the case and has demanded that Kortaþjónustan's claims be rejected. Kortaþjónustan's court-appointed evaluator has given a report on its alleged loss. The Bank and the defendants in the case have demanded a reassessment. The Group has not recognised a provision in relation to this matter.

Contingent assets

Settlement of the 2011 Byr acquisition

The Group acquired Byr hf. ("Byr"), a former savings bank, in 2011 from the Byr Winding-up Committee ("Committee") and the Icelandic Ministry of Finance and Economic Affairs ("Ministry"). According to standard practice, the Group retained the right to re-evaluate the fair value of the net assets acquired and to demand a refund if the fair value of the net assets was not in line with what was presented in Byr's financial statements. Based on this, the Group filed a claim amounting to ISK 6,943 million plus interest with the Committee in June 2013. The claim is filed as a priority claim, according to Article 110 of the Act on Bankruptcy no. 21/1991 The Committee rejected the claim with a letter dated 30 September 2013. At a creditors' meeting in December 2013 it was decided that the Committee would refer the dispute to the District Court of Reykjavík. A formal claim amounting to ISK 911 million plus interest was filed with the Ministry on 24 September 2014. Both claims have now been filed with the District Court of Reykjavík. Furthermore, at the request of the Group, the District Court has appointed two independent professionals to perform a formal evaluation of the Group's claim on the Ministry and the Committee. The evaluation is expected to be completed in 2017. Court proceedings are expected to commence once the evaluation has been completed and filed with the Court. The Group has not recognised any revenues relating to this claim.

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

Events after the balance sheet date

57. No events have arisen after the reporting period that require amendments or additional disclosures in the consolidated financial statements for the year ended 31 December 2016.

Notes to the Consolidated Financial Statements

Risk management

58. Risk governance

Íslandsbanki is exposed to various risk factors and managing these risks is an integral part of the Bank's operations. Risk governance within Íslandsbanki is based on a three lines of defence framework and aims for informed decision-making and strong risk awareness throughout the Bank.

The Bank's management body has a dual structure. The Board of Directors has a supervising role in monitoring the execution of set policies, the sound control of accounting and financial management and ensures that group internal audit, compliance and risk management are effective at all times. The Chief Executive Officer, the Chief Risk Officer, other members of the senior management and the senior management committees are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation.

The ultimate responsibility for ensuring an adequate risk management and internal control framework at Íslandsbanki lies with the Board of Directors. The Board defines and communicates the risk governance framework and the acceptable level of risk through the Bank's Risk Management and Internal Control Policy, the Risk Appetite Statement and other risk management policies.

The Chief Executive Officer (CEO) is responsible for the day-to-day operations of the Bank, pursuant to set policies and resolutions of the Board. Moreover, it is the task of the CEO to ensure that the Bank's operations are consistent at all times with applicable legislation and the Bank's Articles of Association which includes maintaining adequate and effective risk management and internal control functions. The CEO appoints the Chief Risk Officer (CRO), the Compliance Officer as well as other members of the Executive Board and other senior management committees.

The Chief Risk Officer (CRO) heads the Risk Management department and is responsible for defining the daily tasks of the department and to assess the adequacy of its professional skills. In addition, the CRO is responsible for monitoring the risk management framework at the Bank. The CRO is selected and appointed by the CEO, subject to Board confirmation. The CRO reports directly to the Board and the Board Risk Committee on the overall risk profile of the group.

Risk Management is responsible for implementing the Bank's risk strategy and policies, for verifying that the Bank has in place efficient risk management processes and that each key risk that the Bank faces is identified and properly managed by the relevant units. Risk Management provides independent information, analyses and expert judgement on risk exposures, and advice on proposals and risk decisions made by the management and business or support units as to whether they are consistent with the risk appetite and risk polices set by the Board. Risk Management reports on risk, and compliance to limits to internal and external stakeholders, and ensures an appropriate escalation in the event of limit breaches.

The Compliance Officer heads the Compliance function and is responsible for defining the daily tasks of the department and assessing the adequacy of its professional skills. The Compliance Officer maintains oversight for compliance risk throughout the Bank. The Bank's Compliance Officer is selected and appointed by the CEO, subject to Board confirmation, and reports directly to the CEO.

The Chief Audit Executive (CAE) is appointed by the Board, reports directly to the Board and directs Group Internal Audit with a mandate from the Board. The CAE is responsible for internal audit matters within the Bank, including outsourced projects. The Internal Audit is not responsible for internal control or its implementation, but provides the Bank with independent, objective assurance and consulting services designed to add value and improve the Bank's operations. It helps the Bank to evaluate and improve the effectiveness of its risk management, controls, and governance processes

In January 2017, the Board of Íslandsbanki approved changes to the Bank's risk governance and committee structure to further support the three lines of defence framework. The changes are described in the unaudited Pillar 3 Report.

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Credit risk

59. Credit risk is defined as current or prospective risk to earnings and capital arising from an obligor's potential failure to meet the terms of any contract with the Group or to otherwise fail to perform as agreed.

This risk comprises default risk, recovery risk, country risk, settlement risk and credit concentration risk.

Credit concentration risk is the significantly increased risk that is driven by common underlying factors, e.g. sector, economy, geographical location, type of financial instrument or due to connections or relations among counterparties. This includes large individual exposures to parties under common control and significant exposures to groups of counterparties whose likelihood of default is driven by common underlying factors.

Credit risk arises principally from the Group's loans and advances to customers and other banks but also from balances with the Central Bank and off-balance sheet items such as guarantees, loan commitments and derivatives.

The Bank has policies and procedures dedicated to accepting, measuring, and managing credit risk. The objective of the Bank's credit risk management is to achieve an appropriate balance between risk and return and to minimise potential adverse effects of credit risk on the Group's financial performance.

A thorough analysis of the counterparty's financial standing, analysis of past and estimated future cash flows as well as the borrower's general ability to repay its obligations forms the basis for all credit decisions. The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, groups of borrowers, countries and industry segments. The Bank measures and consolidates its credit risk for each counterparty or group of connected clients in accordance with internal and external criteria of connection between parties.

The Bank employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of security in borrower's assets. The principal collateral types for loans are real properties, vehicles, equipment, vessels and securities. When applicable, other credit risk mitigants are employed.

60. Maximum credit exposure

The Group's credit risk exposure comprises both on-balance sheet and off-balance sheet items. Maximum exposure to credit risk for on-balance sheet assets is the net carrying amount as reported in the statement of financial position before the collective impairment allowance is subtracted, see Note 31. The maximum exposure for off-balance sheet items is the amount that the Group might have to pay out against financial guarantees and loan commitments, less provisions the Group has made because of these items. The maximum credit exposure for a derivative contract is calculated by adding future credit exposure to the market value of the contract as described in Chapter 6 of the Regulation (EU) no. 575/2013 of the European Parliament.

The industry breakdown shows the Group's credit exposure by industry classification. The breakdown follows an internal industry classification which is based on the Icelandic ISAT2008 that derives from the European NACE Rev. 2 classification standard.

The Group's credit exposure, before taking account of any collateral held or other credit enhancements, is as follows:

Credit risk exposure

60. Cont'd

Maximum credit exposure at 31 December 2016

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	275,453	-	-	-	-	-	-	-	-	-	275,453
Bonds and debt instruments	-	24,928	-	-	-	3,885	1,638	150	4	651	-	31,256
Derivatives	4	-	210	-	990	3,155	46	120	-	179	683	5,387
Loans to credit institutions	-	-	105	-	-	17,540	-	-	-	-	-	17,645
Loans to customers:	286,177	-	97,943	27,878	7,216	85	63,090	14,402	12,835	100,020	80,243	689,889
Overdrafts	11,540	-	9,587	3,586	2	16	6,309	578	932	2,922	9,911	45,383
Credit cards	16,788	-	1,514	209	3	28	407	34	108	60	37	19,188
Mortgages	211,233	-	-	-	-	-	-	-	-	-	-	211,233
Capital leases	8,397	-	20,782	2,049	8	0	7,534	216	83	1,147	200	40,415
Other loans	38,219	-	66,060	22,034	7,203	41	48,840	13,574	11,712	95,891	70,095	373,670
Other financial assets	342	6	251	52	2	5,303	97	126	5	85	24	6,293
Off-balance sheet items:												
Financial guarantees	1,605	-	4,953	2,751	-	1,666	1,596	62	4	681	505	13,823
Undrawn loan commitments	-	-	2,197	6,704	9,675	-	16,972	526	-	8,223	1,881	46,178
Undrawn overdrafts	9,997	-	9,669	1,868	250	3,504	3,850	469	2,609	2,432	2,977	37,625
Credit card commitments	25,869	1	4,212	630	32	165	1,125	129	835	274	172	33,444
Total maximum credit exposure	323,994	300,388	119,540	39,883	18,165	35,303	88,414	15,984	16,292	112,545	86,486	1,156,994

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60. Cont'd

Maximum credit exposure at 31 December 2015

	Individuals	Central governments	Commerce and services	Construction	Energy	Financial services	Industrial and transportation	Investment companies	Public sector and non-profit organisations	Real estate	Seafood	Total
Cash and balances with CB	-	216,760	-	-	-	-	-	-	-	-	-	216,760
Bonds and debt instruments	-	72,876	1,530	-	-	3,067	306	506	16	304	-	78,605
Derivatives	5	-	23	-	1,208	3,073	22	15	-	13	53	4,412
Loans to credit institutions	-	-	-	-	-	35,534	-	-	-	-	-	35,534
Loans to customers:	272,610	-	89,781	23,013	3,737	105	60,726	19,362	13,878	99,094	85,872	668,178
Overdrafts	11,931	-	9,632	3,924	15	37	6,223	1,047	790	3,408	1,647	38,654
Credit cards	15,847	-	1,448	201	4	27	391	33	127	51	37	18,166
Mortgages	197,307	-	-	-	-	-	-	-	-	-	-	197,307
Capital leases	8,451	-	20,633	1,934	9	1	6,413	188	119	1,180	232	39,161
Other loans	39,074	-	58,069	16,954	3,709	40	47,699	18,093	12,841	94,455	83,957	374,891
Other financial assets	233	12	137	3	1	4,234	14	80	1	738	82	5,535
Off-balance sheet items:												
Financial guarantees	1,406	-	3,445	2,592	-	1,668	1,831	52	29	219	363	11,605
Undrawn loan commitments	-	-	1,385	9,339	10,222	-	11,207	757	-	4,226	5,549	42,685
Undrawn overdrafts	9,636	-	9,007	1,834	209	3,198	3,103	404	2,482	1,595	1,663	33,131
Credit card commitments	25,360	2	3,677	520	36	169	998	162	802	227	162	32,115
Total maximum credit exposure	309,250	289,650	108,985	37,301	15,413	51,048	78,207	21,338	17,208	106,416	93,745	1,128,560

Comparative amounts have been adjusted and ISK 2,957 million moved from the line item Capital leases to the line item Other loans.

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61. Credit exposure covered by collateral

Collateral and other credit mitigants vary between types of obligors and credit facilities. Loans to credit institutions are usually unsecured. For loans to individuals the principal collateral taken is residential property against mortgages. In the case of corporate entities the Group takes a charge over assets such as real estate, fishing vessels, cash and securities and as well as other collateral including accounts receivables, inventory, vehicles and equipment. Loans to government entities and to municipalities are more often than not unsecured. Derivative exposures are generally made under ISDA master agreements with Credit Support Annex or corresponding terms with pledged collateral in the form of cash and government bonds.

In some cases the Group uses guarantees as a credit enhancement but since guarantees effectively transfer credit risk from one counterparty to another they do not represent a reduction in maximum exposure to credit risk. Covenants in loan agreements are also an important credit enhancement but do not reduce maximum credit exposure.

Valuation of collateral is based on market price, official valuation for tax purposes or expert opinion of the Group's employees, depending on availability. In the case of fishing vessels the associated fishing quota is included in the valuation. Collateral is allocated according to claim value of loans, not carrying amount, and is measured without including the effect of overcollateralisation. This means that if some loans have collateral values in excess of their claim value, then the excess is removed in order to reflect the Group's actual maximum exposure to credit risk. The total value of pledged assets can thus be higher than the cover indicates.

For capital leases the Group remains the owner of the leased object. In the table below ISK 33,421 million of the collateral are leased objects.

An estimate of the collateral held by the Group against credit exposure is shown below:

At 31 December 2016	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	4,631	-	-	4,631
Loans and commitments to customers:	449,999	70,510	8,770	40,329	40,524	610,132
Individuals	236,215	32	552	11,426	135	248,360
Commerce and services	48,987	623	128	20,694	10,026	80,458
Construction	25,679	100	738	1,548	3,246	31,311
Energy	2,887	-	415	-	8	3,310
Financial services	41	-	144	-	-	185
Industrial and transportation	25,770	3,389	356	6,164	11,652	47,331
Investment companies	4,782	8	2,596	88	4,190	11,664
Public sector and non-profit organisations	939	-	6	71	-	1,016
Real estate	99,306	-	3,812	163	727	104,008
Seafood	5,393	66,358	23	175	10,540	82,489
Total	449,999	70,510	13,401	40,329	40,524	614,763

At 31 December 2015	Real estate	Vessels	Cash & securities	Vehicles & equipment	Other collateral	Credit exposure covered by collateral
Derivatives	-	-	3,181	-	-	3,181
Loans and commitments to customers:	425,053	78,274	6,416	38,604	42,650	590,997
Individuals	223,131	33	688	10,329	45	234,226
Commerce and services	46,418	422	344	19,902	8,719	75,805
Construction	20,856	154	208	1,953	2,360	25,531
Energy	2,895	-	414	9	88	3,406
Financial services	40	-	24	1	-	65
Industrial and transportation	23,776	6,208	411	5,797	10,765	46,957
Investment companies	5,056	10	3,460	91	7,524	16,141
Public sector and non-profit organisations	1,034	-	9	105	-	1,148
Real estate	96,805	-	572	207	562	98,146
Seafood	5,042	71,447	286	210	12,587	89,572
Total	425,053	78,274	9,597	38,604	42,650	594,178

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62. Credit quality of financial assets

Loans are classified as impaired loans if there is objective evidence that an impairment loss has incurred. The carrying amount is then reduced through the use of an allowance account to the present value of expected future cash flows, discounted at the effective interest rate of the corresponding loans.

The full carrying amount of all loans which give rise to individual impairment is included in impaired loans, even if parts are covered by collateral. The collective impairment has not been subtracted from the carrying amount here.

Further disclosure on past due but not impaired loans can be found in Note 64.

At 31 December 2016	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	275,453	-	-	275,453
Bonds and debt instruments	31,256	-	-	31,256
Derivatives	5,387	-	-	5,387
Loans to credit institutions	17,645	-	-	17,645
Loans to customers:	663,124	21,448	5,317	689,889
Individuals	272,963	11,648	1,566	286,177
Commerce and services	94,604	2,303	1,036	97,943
Construction	26,654	561	663	27,878
Energy	7,216	-	-	7,216
Financial services	44	41	-	85
Industrial and transportation	58,579	3,748	763	63,090
Investment companies	14,033	363	6	14,402
Public sector and non-profit organisations	12,825	3	7	12,835
Real estate	97,181	1,764	1,075	100,020
Seafood	79,025	1,017	201	80,243
Other financial assets	6,253	40	-	6,293
Total	999,118	21,488	5,317	1,025,923

At 31 December 2015	Neither past due nor impaired	Past due but not impaired	Classified as impaired	Total carrying amount
Cash and balances with Central Bank	216,760	-	-	216,760
Bonds and debt instruments	78,606	-	-	78,606
Derivatives	4,412	-	-	4,412
Loans to credit institutions	35,534	-	-	35,534
Loans to customers:	636,685	23,572	7,921	668,178
Individuals	253,798	15,443	3,369	272,610
Commerce and services	87,102	1,517	1,162	89,781
Construction	21,655	583	775	23,013
Energy	3,737	-	-	3,737
Financial services	65	40	-	105
Industrial and transportation	59,267	885	574	60,726
Investment companies	18,476	580	306	19,362
Public sector and non-profit organisations	13,839	39	-	13,878
Real estate	96,243	1,562	1,289	99,094
Seafood	82,503	2,923	446	85,872
Other financial assets	4,748	787	-	5,535
Total	976,745	24,359	7,921	1,009,025

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63. Neither past due nor impaired loans

The Bank uses internal rating models to assess the default probability of corporate and retail customers. The models assign each customer to one of ten risk classes. One risk class is for customers in default (risk class 10), and nine risk classes are for performing customers (risk classes 1-9). Risk classes are assigned on customer level and not facility level.

The rating of corporate customers is based on a company's most recent financial statement, together with a qualitative assessment of its management, market position and industry sector.

For retail customers the Bank uses two different statistical rating models. One model is for individuals and another is for small companies with a total exposure to the Bank of less than ISK 150 million. These models are behavioural scoring models and use information about a customer's payment history, amount of debt and deposits, and demographic variables to assess the probability that a customer will default on any of his obligations within 12 months of the rating assessment.

The table below shows loans that are neither past due nor impaired aggregated in five customer groups based on the default probability. Group 1-4 represents low risk, group 5-6 moderate risk, group 7-8 increased risk, risk class 9 high risk, and risk class 10 represents customers in default. Unrated are loans originating from subsidiaries of Íslandsbanki that do not have rating models, in addition to loans that are yet to be rated or with an expired rating.

The same customer can have loans that are more than 90 days past due or impaired, and at the same time other loans that are neither past due nor impaired. Those customers will be in risk class 10 and their loans that are neither past due nor impaired are included in the table below.

At 31 December 2016	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers:							
Individuals	12,033	104,940	107,085	43,474	1,809	3,622	272,963
Commerce and services	26,975	47,752	14,924	3,279	149	1,525	94,604
Construction	1,189	13,686	9,422	1,855	413	89	26,654
Energy	3,023	3,341	852	-	-	-	7,216
Financial services	21	8	13	1	-	1	44
Industrial and transportation	16,828	28,877	9,070	3,416	388	-	58,579
Investment companies	988	4,719	7,556	614	4	152	14,033
Public sector and non-profit organisations	6,731	5,863	208	23	-	-	12,825
Real estate	25,555	45,571	22,929	2,931	4	191	97,181
Seafood	34,411	38,147	4,880	1,530	57	-	79,025
Total	127,754	292,904	176,939	57,123	2,824	5,580	663,124

At 31 December 2015	Risk class 1-4	Risk class 5-6	Risk class 7-8	Risk class 9	Risk class 10	Unrated	Total
Loans to customers:							
Individuals	11,793	99,967	91,329	44,290	2,418	4,001	253,798
Commerce and services	13,264	53,916	15,418	3,357	294	853	87,102
Construction	657	10,676	7,659	2,130	506	27	21,655
Energy	353	3,243	141	-	-	-	3,737
Financial services	36	9	20	-	-	-	65
Industrial and transportation	14,329	30,049	12,207	2,507	87	88	59,267
Investment companies	4,735	7,029	5,235	1,328	149	-	18,476
Public sector and non-profit organisations	5,605	8,048	175	3	7	1	13,839
Real estate	29,490	42,952	21,177	2,403	50	171	96,243
Seafood	36,848	33,065	11,372	327	892	-	82,504
Total	117,110	288,954	164,733	56,345	4,403	5,141	636,686

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64. Past due but not impaired loans

Past due but not impaired loans are loans where contractual interest or principal payments have passed due date by more than three days without the obligor making full payment, but where specific impairment is not appropriate. The reason is usually that contractual payments are eventually expected to be fulfilled or these loans are expected to be restructured without any loss to the Group. The loss is then usually avoided because there is sufficient collateral.

Payments three days in arrears or less are not considered to have informational value regarding credit quality. The majority of these loans are loans to individuals where the authorised overdraft limit has expired and will be renewed again. On 31.12.2016 loans with payments three days in arrears or less amounted to ISK 61 million but on 31.12.2015 the corresponding figure was ISK 39 million.

Amounts reported as loans past due refer to the total loan exposure and not only the payment or sum of payments that are past due. Past due but not impaired assets are as follows:

At 31 December 2016	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:	10,204	2,628	1,365	7,251	21,448
Individuals	6,477	1,918	588	2,665	11,648
Commerce and services	1,281	324	409	289	2,303
Construction	247	55	97	162	561
Financial services	-	-	-	41	41
Industrial and transportation	385	140	78	3,145	3,748
Investment companies	115	71	65	112	363
Public sector and non-profit organisations	1	1	1	-	3
Real estate	1,264	113	116	271	1,764
Seafood	434	6	11	566	1,017
Other financial assets	36	1	-	3	40
Total	10,240	2,629	1,365	7,254	21,488

At 31 December 2015	Past due 4-30 days	Past due 31-60 days	Past due 61-90 days	Past due more than 90 days	Total past due loans
Loans to customers:	10,351	4,975	1,292	6,954	23,572
Individuals	7,322	3,156	432	4,533	15,443
Commerce and services	544	460	300	213	1,517
Construction	413	114	8	48	583
Financial services	-	-	-	40	40
Industrial and transportation	499	106	13	267	885
Investment companies	289	72	72	147	580
Public sector and non-profit organisations	27	10	-	2	39
Real estate	614	577	42	329	1,562
Seafood	643	480	425	1,375	2,923
Other financial assets	765	-	-	22	787
Total	11,116	4,975	1,292	6,976	24,359

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65. Restructuring and forbearance

When restructuring measures are believed to be more appropriate than collection procedures then the Bank can offer several debt relief measures and restructuring frameworks for its customers in financial difficulties. These forbearance measures include temporary payment holidays, extension of loan terms, capitalisation of arrears and waiving of covenants. In many cases these measures are precursors to the more formal restructuring process.

66. Assets obtained by taking possession of collateral

Details of non-financial assets obtained by the Group during the year by taking possession of collateral held as security against loans.

	2016	2015
Property and land	2,701	3,504
Industrial equipment and vehicles	96	179

The Group pursues realisation of the collateral in an orderly manner. The Group does not generally use the non-cash collateral for its own operations. The Group's employees are not permitted to purchase foreclosed assets.

67. Large exposure disclosure

When the Group's total exposure to a group of connected clients is 10% or higher of the Group's capital base it is considered a large exposure. Both on-balance sheet and off-balance sheet items from all types of financial instruments are included in the exposure as defined by the Financial Supervisory Authority rules no. 625/2013. The Bank has internal criteria that define connections between clients. These criteria reflect the Bank's interpretation of Article (1)(a) of law no. 161/2002 on Financial Undertakings, where groups of connected clients are defined.

The exposure is evaluated both before and after credit risk mitigating effects eligible according to the Financial Supervisory Authority rules. After mitigating effects, the Group has currently two large exposures which are 13% and 12%, respectively, of its capital base. No large exposure is above the maximum 25% single large exposure limit set by the law.

The following tables show the Group's large exposures as a percentage of the Group's capital base, before and after eligible credit risk mitigating effects. Note that group references might change between reporting periods, i.e. Group 1 might not be the same group in the two tables.

		31.12.2016
Client groups	Before	After
Group 1	159%	0%
Group 2	13%	13%
Group 3	12%	12%

		31.12.2015
Client groups	Before	After
Group 1	117%	0%
Group 2	12%	12%

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Liquidity risk

68. The Group defines liquidity risk as the risk of not being able to fund its financial obligations or planned growth, or only being able to do so substantially above the prevailing market cost of funds.

Liquidity risk management

The Group's main source of funding is customer deposits. The Bank's Treasury is responsible for the Bank's funding and liquidity management within the limits approved by the Board and the Asset and Liability Committee. The Interbank desk manages the Group's intraday liquidity.

Risk management is responsible for measuring, monitoring and reporting on the Group's liquidity position.

The Group's liquidity risk policy assumes that the Group has at all times sufficient liquidity to meet liabilities and other obligations over the next twelve months.

Key measures for the assessment of liquidity risk are the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) introduced by the Basel Committee on Banking Supervision in 2010 and incorporated into European law through the CRD IV.

In preparation for the lifting of capital controls in Iceland, the implementation of the LCR and the NSFR has been ahead of that in Europe and special focus has been on setting limits regarding LCR and NSFR in foreign currencies. The Central Bank of Iceland, which is the main supervisory authority regarding liquidity risk, has incorporated the LCR and the NSFR based on the CRD IV standards into the Rules on liquidity ratio and the Rules on funding ratio in foreign currencies.

The minimum LCR requirements are 90% for the overall ratio and 100% for foreign currency denominated assets and liabilities. At the same time the minimum NSFR requirement for foreign currency denominated assets and liabilities are 90%. The table below shows the LCR and NSFR for the group at year-end 2016 and year-end 2015.

Liquidity coverage ratio	31.12.2016	31.12.2015
Total	187%	143%
Foreign currencies	331%	467%

Net stable funding ratio	31.12.2016	31.12.2015
Total	123%	120%
Foreign currencies	144%	141%

The tables below show the contractual payments of principal and interest for the Group's financial liabilities. Thus, the total figures for each liability class are higher than the respective balance sheet amount. Cash flows for payments of unknown nature, such as for floating rate, CPI-linked or foreign currency denominated instruments, are based on internal yield curves and forecasts.

For dated financial liabilities the amounts are grouped into maturity buckets according to contractual maturities of principal and estimated contractual payments of interest. For demand deposits or other non-dated liabilities, the figures are grouped according to the first possible required payment date.

Maturity analysis 31 December 2016

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	475	475	-	-	-	-	-	475
Deposits from CB and credit institutions	4,922	4,922	2	-	-	-	-	4,924
Deposits from customers	594,187	383,060	119,632	60,007	25,133	20,679	-	608,511
Debt issued and other borrowed funds	212,468	2,457	3,779	26,452	155,189	49,353	-	237,230
Other financial liabilities	36,005	30,316	3,102	2,270	317	-	-	36,005
Total financial liabilities	848,057	421,230	126,515	88,729	180,639	70,032	-	887,145

Off-balance sheet liabilities show the amount of contractual obligations that the Group has taken towards customers, either by committing to lend out money in the future or as third party guarantees. The amounts shown reflect the maximum amount, not taking into account the Group's ability to reduce overdraft or credit card limits before the current undrawn amount is fully utilised by the customer. These obligations all fall into the first time bucket since contractually, on a case-by-case basis, the Group could be required to fulfil these obligations instantaneously.

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Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	13,823	-	-	-	-	-	13,823
Undrawn loan commitments	46,178	-	-	-	-	-	46,178
Undrawn overdrafts	37,625	-	-	-	-	-	37,625
Credit card commitments	33,444	-	-	-	-	-	33,444
Total	131,070	-	-	-	-	-	131,070
Total non-derivative financial liabilities and off-balance sheet liabilities	552,300	126,515	88,729	180,639	70,032	-	1,018,215

The table below shows the contractual cash flow of the Group's derivative liabilities, i.e. derivatives that have a negative carrying amount at the date of reporting. Derivatives with a positive carrying amount are detailed separately. For derivatives settled on a gross basis, the cash flow for both legs of the derivative is shown, since netting cannot be applied upon settlement.

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	28,809	11,141	72,281	6,280	-	118,511
Outflow	-	(29,356)	(11,653)	(73,586)	(7,063)	-	(121,658)
Total	-	(547)	(512)	(1,305)	(783)	-	(3,147)
Net settled derivatives	-	(139)	-	-	-	-	(139)
Total	-	(686)	(512)	(1,305)	(783)	-	(3,286)

Maturity classification of assets is based on contractual maturity. For bonds and debt instruments in the banking book the maturity classification is based on contractual maturity dates while for bonds and debt instruments held for trading the maturity classification is based on the estimated liquidation time of the asset.

In the table below the total amount for loans to customers is shown before latent impairment allowance and is therefore higher than the total amount shown in the financial statement.

Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	275,453	76,752	198,701	-	-	-	0	275,453
Bonds and debt instruments	31,256	1,127	11,941	6,475	6,238	5,475	0	31,256
Shares and equity instruments	10,626	-	-	-	-	-	10,626	10,626
Loans to credit institutions	17,645	11,379	6,266	-	-	-	-	17,645
Loans to customers	687,840	4,036	75,625	65,656	190,636	353,935	-	689,888
Other financial assets	6,293	3,057	706	26	84	5	2,415	6,293
Total financial assets	1,029,113	96,351	293,239	72,157	196,958	359,415	13,041	1,031,161

Derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	9,000	2,309	3,098	28	-	14,435
Outflow	-	(8,808)	(1,744)	(2,728)	(40)	-	(13,320)
Total	-	192	565	370	(12)	-	1,115
Net settled derivatives	-	299	-	-	-	-	299
Total	-	491	565	370	(12)	-	1,414

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The tables below show the comparative amounts for financial assets and liabilities at the end of 2015.

Maturity analysis 31 December 2015

Financial liabilities	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Short positions	4,073	4,073	-	-	-	-	-	4,073
Deposits from CB and credit institutions	25,631	18,905	6,862	-	-	-	-	25,767
Deposits from customers	593,245	358,266	128,895	37,110	63,649	20,978	-	608,898
Debt issued and other borrowed funds	150,308	2	5,098	32,107	105,982	29,524	-	172,713
Subordinated loans	19,517	-	-	736	23,542	-	-	24,278
Other financial liabilities	45,034	31,571	4,910	7,620	933	-	-	45,034
Total financial liabilities	837,808	412,817	145,765	77,573	194,106	50,502	-	880,763

Off-balance sheet liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Financial guarantees	11,605	-	-	-	-	-	11,605
Undrawn loan commitments	42,685	-	-	-	-	-	42,685
Undrawn overdrafts	33,131	-	-	-	-	-	33,131
Credit card commitments	32,115	-	-	-	-	-	32,115
Total	119,536	-	-	-	-	-	119,536
Total non-derivative financial liabilities and off-balance sheet liabilities	532,353	145,765	77,573	194,106	50,502	-	1,000,299

Derivative financial liabilities	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	19,749	18,135	55,090	3,284	-	96,258
Outflow	-	(19,994)	(18,675)	(55,481)	(3,815)	-	(97,965)
Total	-	(245)	(540)	(391)	(531)	-	(1,707)
Net settled derivatives	-	(601)	-	-	-	-	(601)
Total	-	(846)	(540)	(391)	(531)	-	(2,308)

Financial assets	Carrying amount	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Cash and balances with Central Bank	216,760	33,221	183,539	-	-	-	-	216,760
Bonds and debt instruments	78,606	1,551	24,160	15,708	33,361	3,826	-	78,606
Shares and equity instruments	18,320	-	-	-	-	-	18,320	18,320
Loans to credit institutions	35,534	31,064	4,470	-	-	-	-	35,534
Loans to customers	665,711	4,723	73,386	52,827	194,904	342,338	-	668,178
Other financial assets	6,675	2,046	926	807	54	6	2,835	6,675
Total financial assets	1,021,606	72,605	286,481	69,342	228,319	346,170	21,155	1,024,072

Derivative financial assets	On demand	Up to 3 months	3-12 months	1-5 years	Over 5 years	No maturity	Total
Gross settled derivatives							
Inflow	-	10,589	9,902	25,286	77	-	45,854
Outflow	-	(10,488)	(9,289)	(24,257)	(57)	-	(44,091)
Total	-	101	613	1,029	20	-	1,763
Net settled derivatives	-	207	-	-	-	-	207
Total	-	308	613	1,029	20	-	1,970

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As a part of managing liquidity risk, the Group holds a portfolio of liquid assets to meet unexpected outflow of funds or a temporary shortage in access to new funding. These assets are subject to strict criteria with respect to credit quality, liquidation time and price volatility. The table below shows the composition and amount of the Group's liquidity back-up at the end of 2016 and end of 2015.

Composition and amount of liquidity back-up	31.12.2016	31.12.2015
Cash and balances with Central Bank	240,921	216,760
Domestic bonds eligible as collateral against borrowing at the Central Bank	5,722	21,218
Foreign government bonds	19,081	41,330
Loans to credit institutions	17,109	35,143
Composition and amount of liquidity back-up	282,833	314,451

69. Deposits by LCR category

The Group's deposits are categorised according to the Liquidity Coverage Ratio (LCR) introduced in the Basel III standards. The groups are listed in order of estimated stability and the respective LCR outflow weight. Deposits are also classifed as stable if the customer has an established business relationship with the Bank and is covered by an effective insurance scheme.

31 December 2016	Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	105,126	10%	55,809	5%	69,619	230,554
SMEs	51,540	10%	13,597	5%	7,061	72,198
Operational relationships	2,679	25%	-	5%	-	2,679
Corporations	58,662	40%	254	20%	34,929	93,845
Sovereigns, Central Bank and public sector entities	6,898	40%	221	20%	655	7,774
Financial institutions in composition	4,949	100%	-	-	3,000	7,949
Pension funds	22,863	100%	-	-	26,756	49,619
Domestic financial entities	46,493	100%	-	-	34,429	80,922
Foreign financial entities	1,946	100%	-	-	32,402	34,348
Other foreign entities	8,585	100%	2,000	25%	8,636	19,221
Total	309,741		71,881		217,487	599,109

The table below shows the comparative amounts for financial assets and liabilities at the end of 2015.

31 December 2015	Deposits maturing within 30 days					
	Less stable	Weight (%)	Stable	Weight (%)	Term deposits	Total deposits
Retail	93,385	10%	56,443	5%	56,122	205,950
SMEs	47,394	10%	13,340	5%	5,897	66,631
Operational relationships	2,050	25%	-	5%	-	2,050
Corporations	66,306	40%	235	20%	25,509	92,050
Sovereigns, Central Bank and public sector entities	5,723	40%	257	20%	970	6,950
Financial institutions in composition	58,428	100%	-	-	39,783	98,211
Pension funds	23,775	100%	-	-	26,765	50,540
Domestic financial entities	32,601	100%	-	-	20,919	53,520
Foreign financial entities	19,033	100%	-	-	1,636	20,669
Other foreign entities	17,936	100%	1,956	25%	2,413	22,305
Total	366,631		72,231		180,014	618,876

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Market risk

70. The Group defines market risk as the current or prospective risk to earnings and capital arising from adverse movements in the level or volatility of prices of market instruments, such as those that arise from changes in interest rates, equity prices, commodity prices and foreign exchange rates.

Market risk management

The Group's market risk appetite is determined by the Board of Directors. The Asset and Liability Committee (ALCO) decides on limits for portfolios and products in accordance with the risk appetite statement and market risk policy approved by the Board. Risk management is responsible for monitoring and reporting on the Group's overall market risk positions and compliance to limits. The objective of market risk management is to manage and control market risk exposures within the Board approved risk appetite.

The Group separates exposures to market risk into trading book and banking book (non-trading portfolios). The Group's primary sources of market risk in the trading portfolio are listed shares, listed debt instruments and foreign currency positions. All financial assets and liabilities in the trading portfolio are recognised at fair value and all resulting changes are immediately reflected in the income statement. Market risk in the banking book is mainly due to mismatches in interest rate terms and denomination currency and indexation of assets and liabilities. These mismatches are reported to management and are subject to internal and regulatory limits.

Interest rate risk

71. Interest rate risk is defined as the current or prospective risk to earnings or capital arising from adverse movements in interest rates.

The Group uses sensitivity measures like Basis Point Value (BPV) to measure and manage risk arising from its fixed income exposures. The BPV measures the effect of a 0.01% (0.01 percentage point) upward parallel shift in the yield curve on the fair value of these exposures.

72. Interest rate risk in the trading portfolios

The fixed income trading unit invests mainly in government bonds, bonds issued by the Housing Financing Fund (HFF) which are guaranteed by the Icelandic government, but also domestic municipality bonds and covered bonds issued by the Icelandic banks. These positions can include short positions. Government bonds are either indexed to the Icelandic Consumer Price Index (CPI) or non-indexed, with duration up to 11 years. HFF bonds are CPI-linked and have duration up to 12 years. All bond trading positions are subject to BPV limits, both intraday and end-of-day. In addition to BPV limits, short and long positions in each instrument are subject to separate notional limits.

In the table below the total market value (MV) of long and short positions may not be exactly the same as reported in Note 7 since netting between short and long positions is not applied here. Derivatives used for hedging are excluded from the table. The market value of long positions at 31.12.2015 has been corrected and lowered by ISK 340 million.

Trading bonds and debt instruments, long positions	31.12.2016			31.12.2015		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	1,210	7.35	(0.89)	1,818	8.08	(1.47)
Non-indexed	23,499	0.37	(0.88)	43,363	0.32	(1.42)
Total	24,709	0.72	(1.77)	45,181	0.63	(2.89)

Trading bonds and debt instruments, short positions	31.12.2016			31.12.2015		
	MV	Duration	BPV	MV	Duration	BPV
Indexed	371	11.37	0.42	1,754	7.04	1.24
Non-indexed	488	2.60	0.13	3,057	1.10	0.34
Total	859	6.39	0.55	4,811	3.27	1.58

Net position of trading bonds and debt instruments	23,850	0.51	(1.22)	40,370	0.32	(1.31)

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The Bank's liquidity management assumes that part of the liquidity portfolio in foreign currencies can be invested in highly liquid bills issued by foreign governments with a long-term issuer rating of AA- from S&P or Fitch or Aa3 from Moody's. At year-end 2016 the Group held a significant amount of foreign AAA and AA+ credit-rated government bills for liquidity management purposes. These bills have a duration ranging up to six months.

Foreign government bills	31.12.2016		31.12.2015	
Country	MV	BPV	MV	BPV
Belgium	2,388	(0.07)	-	-
France	2,980	(0.02)	6,366	(0.14)
Germany	5,965	(0.09)	13,439	(0.30)
Netherlands	5,969	(0.13)	12,025	(0.25)
Norway	654	(0.03)	1,471	(0.07)
USA	1,126	-	8,030	(0.09)
Total	19,082	(0.34)	41,331	(0.85)

73. Sensitivity analysis for interest rate risk in the trading portfolios

For the sensitivity analysis in the trading portfolio the Group uses as a reference the 99th percentile shift based on historical data of either past five years (domestic rates) or ten years (foreign rates) and a holding period of 20 days. The following table demonstrates the sensitivity of the Group's equity and income statement to these changes in interest rates, all other risk factors held constant. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2015 and the figures for year-end 2015 have been updated accordingly.

Sensitivity analysis for trading bonds and debt instruments		31.12.2016		31.12.2015	
		Profit or (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	85	71	(71)	125	(125)
ISK, non-indexed	90	36	(36)	38	(38)
EUR	25	8	(8)	17	(17)
USD	55	4	(4)	11	(11)
Other total	55	2	(2)	4	(4)
Total		121	(121)	195	(195)

74. Interest rate risk in the non-trading portfolio

Interest rate risk in the banking book arises from the Group's core banking activities. The main source of this type of interest rate risk is the risk of loss from fluctuations in future cash flows or fair value of financial instruments as interest rates change over time, reflecting the fact that the Group's assets and liabilities are of different maturities and are priced relative to different interest rates.

The Group uses traditional measures for assessing the sensitivity of the Group's financial assets, financial liabilities and earnings to changes

In the table below the total amount for loans to customers is shown before collective impairment allowance is subtracted and is therefore not the same as the total amount shown in the financial statement. Note that this also applies for loans to customers shown at 31 December 2015. Loans with specific impairment have been placed in the category 0-3 months since their value is based on the collateral value and thus not sensitive to changes in interest rates until possibly after debt restructuring.

The table below displays assets and liabilities in the non-trading portfolio according to the next interest rate date as of 31 December 2016.

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	240,991	34,462	-	-	-	-	275,453
Bonds and debt instruments	2,317	351	117	23	-	-	2,808
Loans to credit institutions	17,645	-	-	-	-	-	17,645
Loans to customers	468,174	31,785	29,881	149,671	2,729	7,648	689,888
Total assets	729,127	66,598	29,998	149,694	2,729	7,648	985,794
Off-balance sheet items	65,652	9,201	39,609	6,192	-	-	120,654
Effect of derivatives held for hedging	-	-	-	55,932	-	-	55,932
Liabilities							
Deposits from Central Bank and credit institutions	4,922	-	-	-	-	-	4,922
Deposits from customers	573,260	12,108	-	8,819	-	-	594,187
Debt issued and other borrowed funds	25,748	10,207	50,916	81,974	43,623	-	212,468
Total liabilities	603,930	22,315	50,916	90,793	43,623	-	811,577
Off-balance sheet items	74,727	3,509	5,961	32,888	2,996	-	120,081
Effect of derivatives held for hedging	56,002	-	-	-	-	-	56,002
Net interest gap on 31 December 2016	60,120	49,975	12,730	88,137	(43,890)	7,648	174,720

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The table below displays assets and liabilities in the non-trading portfolio according to the next interest rate date as of 31 December 2015.

Assets	0-3 months	3-12 months	1-2 years	2-5 years	5-10 years	Over 10 years	Total
Balances with Central Bank	216,760	-	-	-	-	-	216,760
Bonds and debt instruments	32,034	458	952	108	426	185	34,163
Loans to credit institutions	35,531	3	-	-	-	-	35,534
Loans to customers	463,177	22,748	38,187	130,927	2,431	8,241	665,711
Total assets	747,502	23,209	39,139	131,035	2,857	8,426	952,167
Off-balance sheet items	73,020	9,571	1,456	35,196	-	-	119,243
Liabilities							
Deposits from Central Bank and credit institutions	25,631	-	-	-	-	-	25,631
Deposits from customers	581,171	1,659	1,778	7,772	865	-	593,245
Debt issued and other borrowed funds	35,360	24,180	19,801	48,505	16,053	6,409	150,308
Subordinated loans	19,517	-	-	-	-	-	19,517
Total liabilities	661,679	25,839	21,579	56,277	16,918	6,409	788,701
Off-balance sheet items	87,095	6,446	5,968	28,872	2,976	-	131,357
Net interest gap on 31 December 2015	71,748	495	13,048	81,082	(17,037)	2,017	151,352

75. Sensitivity analysis for interest rate risk in the non-trading portfolios

For the sensitivity analysis in the banking book the Group uses as a reference the 99th percentile shift based on historical data of either past 5 years (domestic rates) or 10 years (foreign rates) and a holding period of six months. The following table demonstrates the sensitivity of the Group's equity and income statement to theses changes in interest rates, all other risk factors held constant and how the applied shifts would affect the fair value of the Group's banking book positions. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2015 and the figures for year-end 2015 have been updated accordingly.

Sensitivity analysis for non-trading bonds and debt instruments		31.12.2016		31.12.2015	
		Profit or (loss)			
Currency (ISK million)	Parallel shift in yield curve (basis points)	Downward shift	Upward shift	Downward shift	Upward shift
ISK, indexed	210	4,583	(4,583)	5,474	(5,474)
ISK, non-indexed	230	(907)	907	(245)	245
CHF	50	3	(3)	(2)	2
EUR	60	(38)	38	(70)	70
GBP	85	0	(0)	2	(2)
JPY	35	2	(2)	1	(1)
USD	130	(39)	39	10	(10)
Other	150	(35)	35	(39)	39
Total		3,569	(3,569)	5,131	(5,131)

Notes to the Consolidated Financial Statements

Currency risk

76. Currency risk is the risk that earnings or capital may be negatively affected from the fluctuations of foreign exchange rates, due to transactions in foreign currencies or due to a mismatch in the currency composition of assets or liabilities.

The analysis of the Group's foreign currency exposure presented below is based on the contractual currency of the underlying balance sheet items. Additionally, there are off-balance sheet items that carry currency risk and are included in the total currency imbalance. The off-balance sheet amounts below represent the notional amounts of derivatives and unsettled spot agreements.

The tables below summarise the Group's exposure to currency risk at 31 December 2016 and 31 December 2015, based on contractual currencies, off-balance sheet items, but excluding assets categorised as held for sale.

Currency analysis 31 December 2016

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	Other	Total
Cash and balances with CB	423	350	203	35	16	108	76	136	44	1,391
Bonds and debt instruments	17,302	2,764	23	-	-	-	654	-	-	20,743
Shares and equity instruments ..	42	1,072	0	-	-	-	0	-	-	1,114
Loans to credit institutions	6,742	8,050	397	207	173	43	1,220	293	465	17,590
Loans to customers	73,192	25,240	1,707	5,165	4,329	2	5,647	776	710	116,768
Other assets	687	1,981	301	1	22	607	2	20	185	3,806
Total assets	98,388	39,457	2,631	5,408	4,540	760	7,599	1,225	1,404	161,412
Liabilities										
Deposits from credit institut.	473	409	0	4	4	0	0	0	0	890
Deposits from customers	19,117	16,303	3,845	333	686	834	2,196	649	472	44,435
Borrowings	97,264	3,963	-	-	-	17,464	6,566	-	-	125,257
Other liabilities	4,572	4,620	643	4	194	611	65	48	317	11,074
Total liabilities	121,426	25,295	4,488	341	884	18,909	8,827	697	789	181,656
Net on-balance sheet position	(23,038)	14,162	(1,857)	5,067	3,656	(18,149)	(1,228)	528	615	(20,244)
Off-balance sheet items										
Off-balance sheet assets	161,505	19,946	2,223	2,619	2,028	19,216	2,063	1,282	2,182	213,064
Off-balance sheet liabilities	138,891	33,967	434	7,733	5,736	1,159	825	1,906	2,554	193,205
Net off-balance sheet position	22,614	(14,021)	1,789	(5,114)	(3,708)	18,057	1,238	(624)	(372)	19,859
Net position	(424)	141	(68)	(47)	(52)	(92)	10	(96)	243	(385)

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76. Cont'd

Currency analysis 31 December 2015

Assets	EUR	USD	GBP	CHF	JPY	SEK	NOK	DKK	Other	Total
Cash and balances with CB	387	250	131	37	11	66	74	90	33	1,079
Bonds and debt instruments	31,829	9,867	-	-	-	-	1,471	-	-	43,167
Shares and equity instruments ..	5,515	276	0	-	-	-	1	-	-	5,792
Loans to credit institutions	18,584	11,474	988	1,027	523	1,420	297	209	511	35,033
Loans to customers	62,438	28,980	5,409	6,907	6,905	272	7,340	1,113	103	119,467
Other assets	432	1,859	246	0	23	35	12	27	47	2,681
Total assets	119,185	52,706	6,774	7,971	7,462	1,793	9,195	1,439	694	207,219
Liabilities										
Deposits from credit institut.	1,389	816	1	440	584	0	0	0	-	3,230
Deposits from customers	66,267	22,351	5,047	1,488	1,031	1,103	2,931	946	1,356	102,520
Borrowings	39,467	-	-	-	-	21,639	7,366	-	-	68,472
Subordinated loans	19,517	-	-	-	-	-	-	-	-	19,517
Other liabilities	4,084	5,066	834	1	118	98	64	163	94	10,522
Total liabilities	130,724	28,233	5,882	1,929	1,733	22,840	10,361	1,109	1,450	204,261
Net on-balance sheet position ...	(11,539)	24,473	892	6,042	5,729	(21,047)	(1,166)	330	(756)	2,958
Off-balance sheet items										
Off-balance sheet assets	71,768	12,667	2,037	833	19	20,833	2,042	424	1,544	112,167
Off-balance sheet liabilities	54,802	36,353	2,694	6,894	5,722	-	2,956	777	603	110,801
Net off-balance sheet position	16,966	(23,686)	(657)	(6,061)	(5,703)	20,833	(914)	(353)	941	1,366
Net position	5,427	787	235	(19)	26	(214)	(2,080)	(23)	185	4,324

77. Sensitivity analysis for currency risk

The table below shows how the currency imbalance is affected by either depreciation or appreciation of each currency assuming other risk factors being held constant. The shift number is the 99th percentile of a 20-day return distribution for each currency for the past 5 years. The adverse movement of each currency is applied for the impact of the shift and demonstrates how the Group's equity and income statement would be affected by the shifts. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2015 and the figures for year-end 2015 have been updated accordingly.

Sensitivity analysis for currency risk 31 December 2016

Currency (shift)	Shift effect
EUR (4%)	(17)
USD (5%)	(10)
GBP (5%)	(3)
CHF (4%)	(2)
JPY (8%)	(4)
SEK (6%)	(6)
NOK (7%)	(1)
DKK (4%)	(4)
Other (5%)	(15)
Total	(62)

Sensitivity analysis for currency risk 31 December 2015

Currency (shift)	Shift effect
EUR (3%)	(163)
USD (7%)	(47)
GBP (4%)	(9)
CHF (9%)	(2)
JPY (7%)	(2)
SEK (5%)	(11)
NOK (6%)	(104)
DKK (3%)	(1)
Other (7%)	(15)
Total	(354)

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Notes to the Consolidated Financial Statements

Shares and equity instruments

78. The Group's equity exposure in the trading book arises from flow trading, mainly in shares denominated in ISK. Limits on both aggregated market value and maximum exposure in single securities are aimed at reducing the equity risk and concentration risk in the Group's portfolio. Shares and equity instruments in the banking book are designated at fair value through profit or loss or are classified as held for sale.

79. Sensitivity analysis for shares and equity instruments
For the sensitivity analysis the Group uses as a reference the 99th percentile shift in the domestic stock index based on historical data of past five years and a holding period of 20 days for the trading book and six months for the banking book. The following table demonstrates how these shifts would affect the Group's equity and net financial income. The shifts have been updated from the ones reported in the consolidated financial statements for the year ended 31 December 2015 and the figures for year-end 2015 have been updated accordingly.

Sensitivity analysis for equities		31.12.2016		31.12.2015	
		Profit or (loss)			
Portfolio (ISK million)	Change in equity prices	Downward shift	Upward shift	Downward shift	Upward shift
Trading	11%	(213)	213	(368)	368
Non-trading	26%	(1,116)	1,116	(2,685)	2,685
Total		(1,329)	1,329	(3,053)	3,053

Derivatives

80. The Group uses derivatives to hedge currency exposure, interest rate risk in the banking book as well as inflation risk. The Group is however subject to indirect exposure through customers' margin trading. Margin trading is subject to continuous monitoring and strict collateral requirements. Other derivatives in the Group held for trading or for other purposes are insignificant.

Inflation risk

81. The Group is exposed to inflation risk since the value of CPI-indexed assets exceeds CPI-indexed liabilities. The value of these assets and liabilities changes according to changes in the CPI at any given time and all changes in the CPI index affect profit and loss. On 31 December 2016 the CPI gap amounted to ISK 60,874 million (2015: ISK 46,776 million). Thus, a 1% increase in the index would lead to an ISK 609 million increase in the balance sheet and a 1% decrease would lead to a corresponding decrease, other risk factors held constant. Note that the following corrections were made to the previously reported figures for 31.12.2015: off-balance sheet positions under both assets and liabilities have been corrected and a new line was added for financial liabilities but they were included in the off-balance sheet position last time.

Assets, CPI -linked	31.12.2016	31.12.2015
Bonds and debt instruments	3,204	2,329
Loans to customers	245,946	223,719
Off-balance sheet position	2,201	5,275
Total assets	251,351	231,323
Liabilities, CPI-linked		
Deposits from customers	95,099	96,424
Debt issued and other borrowed funds	63,510	56,909
Off-balance sheet position	31,771	29,641
Financial liabilities	97	1,573
Total liabilities	190,477	184,547
CPI Balance	60,874	46,776

Capital management

82. Risk exposure and capital base

The table below shows the capital base, risk weighted assets and the resulting capital ratios for the Group at 31 December 2016 and 31 December 2015.

On 31 December 2016, the Group's total capital ratio, calculated according to the Act on Financial Undertakings, was 25.2% compared to 30.1% at year-end 2015.

The decrease of the capital ratios is mainly due to large dividend payments in December 2016 and the repayment of the EUR denominated Tier 2 instrument in September 2016. This reduction was partly offset by the impact of an amendment of the Act on Financial Undertakings which allows for the inclusion of general credit risk adjustments as Tier 2 capital.

The Group aims at managing its capital position and the corresponding capital ratios at a comfortable margin above the overall regulatory capital requirement. The resulting long-term capital target assumes that the Group maintains a capital management buffer of about 0.5-1.5% in excess of the SREP results. Based on last year's SREP results this translates to a long-term total capital ratio target of around 20% and a minimum CET1 ratio above 15%.

The Group still maintains a short-term total capital ratio target of 23%. The higher short-term target is due to some remaining uncertainty regarding the lifting of capital controls and a buffer due to the potential impact of the IFRS 9 implementation. Over the past year, the Group has actively released excess capital by paying dividends to the Icelandic government. The Group expects to continue that course and cautiously manage its capital ratios towards the long-term target over the next 2-3 years.

The Group's regulatory capital calculations for credit risk and market risk are based on the standardised approach and the capital calculations for operational risk are based on the basic indicator approach. Further information regarding the Group's capital management and overall capital requirement can be found in the unaudited Pillar 3 Report.

	2016	2015
Tier 1 capital		
Ordinary share capital	10,000	10,000
Share premium	55,000	55,000
Other reserves	4,139	6,002
Retained earnings	105,563	127,288
Non-controlling interests	4,223	3,937
Tax assets	(4)	-
Intangible assets	(2,672)	(1,331)
Other regulatory adjustments	(924)	(2,779)
Total Tier 1 capital	175,325	198,117
Tier 2 capital		
Qualifying subordinated liabilities	-	19,517
Adjustment to eligible capital instruments	-	(3,903)
Other regulatory adjustments	-	(2,779)
General credit risk adjustments	2,049	-
Total capital base	177,374	210,952
Risk weighted assets		
- due to credit risk	615,465	606,591
- due to market risk:	7,243	16,607
Market risk, trading book	6,418	9,931
Currency risk	825	6,676
- due to operational risk	81,469	76,495
Total risk weighted assets	704,177	699,693
Capital ratios		
Tier 1 ratio	24.9%	28.3%
Total capital ratio	25.2%	30.1%

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82. Cont'd

Article 86 of the Act on Financial Undertakings no. 161/2002 details the measures taken in the case of insufficient own funds of a financial undertaking. If the Board or managing directors of a financial undertaking have reason to expect that its own funds will be less than the minimum required by law, they must immediately notify the Financial Supervisory Authority (FME) thereof. The FME may grant the financial undertaking concerned a time limit of up to six months to increase its own funds to the minimum provided. If the remedies are not satisfactory in the opinion of the FME, or if the time limit provided for expires, the operating licence of the financial undertaking shall be revoked.

Operational risk

83. The Group has adopted the definition of operational risk from the CRD IV of the European Parliament and of the Council, where operational risk is defined “as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk“. The Group's definition of operational risk includes compliance risk and reputational risk.

The Board of Directors has approved an Operational Risk Management Policy, applicable to the Bank, in accordance with article 78 of the Financial Institution Act no. 161/2002. The policy outlines a framework for operational risk management in the Group. The operational risk management framework is described in further detail in several subdocuments, such as the Quality Management Policy, Data Policy, Business Continuity Management Framework, Security Policy, Outsourcing Policy, and the Crisis Communication Policy, all of which are approved by the Executive Board.

According to the Operational Risk Management Policy, the Executive Board is responsible for the operational risk management framework and Risk Management is responsible for the implementation of the operational risk framework throughout the Bank.

The Bank uses the Basic Indicator Approach of the Capital Requirements Directive (CRD) to calculate the capital requirements for Pillar 1 operational risks, in accordance with Rules on the Capital Requirement and Risk Weighted Assets of Financial Undertakings no. 215/2007.

Notes to the Consolidated Financial Statements

Accounting policies

84. Basis of measurement

The consolidated financial statements are prepared on a historical cost basis, except for the following assets and liabilities, which are measured at fair value: bonds and debt instruments, shares and equity instruments, short positions in listed bonds and derivative financial assets and liabilities.

Non-current assets and disposal groups held for sale are measured at the lower of its carrying amount and fair value less costs to sell.

Recognised financial liabilities designated as hedged items in qualifying fair value hedge relationships are measured at amortised cost adjusted for changes in fair value attributable to the risk being hedged.

85. Changes in presentation

The Group has changed its presentation in the consolidated financial statements as follows:

The Group has changed its presentation in the Notes as follows:
- Comparable information in Note 17 in line item Financial assets designated at fair value through profit or loss was included in the line item Other assets in the consolidated financial statements for the year ended 31 December 2015.
- Expenses from non-current assets are included in the line item Net profit from sale of foreclosed mortgages in Note 25, comparable information have not been changed. In the consolidated financial statements for the year ended 31 December 2015 expenses from non-current assets amounted to ISK 264 million were included in Note 22 in the line item Other administrative expenses.

Notes to the Consolidated Financial Statements

86. Significant accounting policies

The accounting policies set out below have been applied consistently by all Group entities to all periods presented in these consolidated financial statements.

Set out below is an index of the significant accounting policies, the details of which are available on the pages that follow.

Contents

86.1. Basis of consolidation

The consolidated financial statements of the Group comprise the financial statements of Íslandsbanki hf., as the parent company, and its subsidiaries presented as those of a single economic entity. The Group consolidates its subsidiaries on the basis of control whereas subsidiaries are entities controlled by the Group.

a) *Control*

The Group controls an entity when the Group is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity.

The Group is exposed, or has rights, to variable returns from its involvement with an entity when the Group's returns from its involvement have the potential to vary as a result of the entity's performance.

The Group has power over an entity when the Group has existing rights that give it the current ability to direct the relevant activities, i.e. the activities that significantly affect the entity's returns.

Generally, there is a presumption that a majority of voting rights results in control. To support this presumption and when the Group has less than a majority of the voting or similar rights of an entity, the Group considers all relevant facts and circumstances in assessing whether it has power over an entity, including the contractual arrangements with the other vote holders of the entity, rights arising from other contractual arrangements, the Group's voting rights and potential voting rights.

When the Group assesses whether it controls an entity, it also determines whether it is a principal or an agent. If the Group has the power to direct the activities of the entity to generate returns for itself, then it is a principal. If the Group is primarily engaged to act on behalf and for the benefit of other parties, then it is an agent and it does not control the entity when exercising its decision-making rights delegated to it. In making the assessment of whether the Group is a principal or an agent it considers the overall relationship between itself, the entity and other parties involved with the entity. In particular, the Group considers the scope of its decision-making authority over the entity, the rights held by other parties, the remuneration to which it is entitled in accordance with any remuneration agreements and the Group's exposure to variability of returns from other interests that it holds in the entity. Different weightings are applied to each of these factors on the basis of particular facts and circumstances.

The Group re-assesses whether or not it controls an entity if facts and circumstances indicate that there are changes to one or more of the elements of control.

b) *Consolidation*

Consolidation of a subsidiary begins when the Group obtains control of the subsidiary and ceases when the Group loses control of the subsidiary.

In preparing the consolidated financial statements, Íslandsbanki hf. combines its financial statements with those of its subsidiaries, line by line, by adding together like items of assets, liabilities, equity, income, expenses and cash flows. When necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies in line with the Group's accounting policies. All intra-group assets and liabilities, equity, income, expenses and cash flows relating to transactions between group entities are eliminated in full on consolidation. The carrying amount of Íslandsbanki hf.'s investment in each subsidiary and Íslandsbanki's portion of equity of each subsidiary are eliminated and any related goodwill is recognised as an asset.

When the Group is committed to a sale plan involving the loss of control of a subsidiary and the criteria for classification as held for sale are met (see Note 86.14), it classifies all the assets and liabilities of that subsidiary as held for sale in its consolidated financial statements. This is regardless of whether the Group will retain a non-controlling interest in the subsidiary after the sale.

When the disposal of subsidiaries meets the definition of discontinued operations (see Note 86.30), the Group presents the gain or loss from disposal in the income statement in the line item “Profit (loss) from discontinued operations, net of income tax”.

If the Group loses control of a subsidiary, it derecognises the related assets (including goodwill), liabilities, non-controlling interests and other components of equity, while any resultant gain or loss is recognised in profit or loss. Any investment retained by the Group in the former subsidiary is recognised at its fair value at the date when control is lost.

A change in the Group's ownership interest in a subsidiary, without a loss of control, is accounted for as an equity transaction.

c) *Non-controlling interests*

Non-controlling interests represent equity in subsidiaries not attributable, directly or indirectly, to the Group.

For each business combination, the Group measures at the acquisition date components of non-controlling interests in the acquiree that are present ownership interests and entitle their holders to a proportionate share of the entity's net assets in the event of liquidation, at either fair value or the present ownership instruments' proportionate share in the recognised amounts of the acquiree's identifiable net assets. All other components of non-controlling interests are measured at their acquisition-date fair values, unless another measurement basis is required by IFRSs.

The Group presents non-controlling interests within equity in the consolidated statement of financial position, separately from the equity attributable to equity holders of Íslandsbanki hf. Profit or loss and each component of other comprehensive income are attributed to equity holders of Íslandsbanki hf. and to non-controlling interests, even if this results in the non-controlling interests having a deficit balance.

86.1. Cont'd

When the proportion of the equity held by non-controlling interests changes, the Group adjusts the carrying amounts of the controlling and non-controlling interests 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 equity holders of Íslandsbanki hf. No adjustments are made to goodwill and no gain or loss is recognised in profit or loss.

d) Business combinations and goodwill

The Group accounts for each business combination by applying the acquisition method. Under the acquisition method, the Group identifies itself as the acquirer, determines the acquisition date, recognises and measures the identifiable assets acquired, the liabilities assumed and any non-controlling interests in the acquiree, and recognises and measures any goodwill or gain from a bargain purchase.

86.2. Foreign currencies

Foreign currency transactions

Items included in the financial statements of each of the Group's entities are measured using the functional currency of the respective entity. Transactions in foreign currencies are translated into functional currencies at the spot exchange rate at the date of the transactions. Monetary assets and liabilities denominated in foreign currencies at the reporting date are retranslated into functional currencies at the spot exchange rate at that date. The foreign currency gain or loss on monetary items is the difference between amortised cost in the functional currency at the beginning of the year, adjusted for effective interest and payments during the year, and the amortised cost in foreign currency translated at the spot exchange rate at the end of the year.

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

Foreign currency differences arising on retranslation are recognised in profit or loss (see Note 86.24).

86.3. Financial assets

For the purpose of measuring its financial assets, the Group classifies them at inception in one of the following categories (see also Note 7):

- Loans and receivables; or
- Financial assets at fair value through profit or loss, either as:
  - held for trading; or
  - designated as at fair value through profit or loss
- Financial assets classified as available for sale.

a) Loans and receivables

Loans and receivables are non-derivative financial instruments with fixed or determinable payments that are not quoted in an active market and that the Group does not intend to sell immediately or in the near-term, other than those that the Group designates upon initial recognition as financial assets at fair value through profit or loss. Loans and receivables include loans originated by the Group to its customers and credit institutions, acquired loans, participations in loans from other lenders and finance receivables.

When the Group 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 repurchase transactions), the arrangement is accounted for as a loan or receivable, and the underlying asset is not recognised in the consolidated financial statements of the Group.

Loans and receivables are recognised when cash is advanced to borrowers. On initial recognition they are measured at fair value plus incremental direct transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the loans and receivables are measured at initial recognition less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums on acquisition and fees and costs that are an integral part of the effective interest rate), and minus any reduction for impairment (see Note 86.28). Accrued interest is included in the carrying amount of the loans and receivables in the statement of financial position.

The losses arising from impairment are recognised in profit or loss in the line item “Net loan impairment”.

86.3. Cont'd

b) *Financial assets designated at fair value through profit or loss*

The Group designates certain financial assets upon their initial recognition as financial assets at fair value through profit or loss when doing so results in more relevant information because:

• It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses from them on different bases; or

• Financial assets and/or financial liabilities are managed and their performance is evaluated on a fair value basis, in accordance with the Group's risk management or investment strategy, and information about it is provided internally on that basis to the Group's key management personnel; or

• The financial assets and/or financial liabilities contain an embedded derivative that significantly modifies the cash flows that would otherwise have been required under the contract.

Financial assets designated by the Group as at fair value through profit or loss are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned (which is recognised in the line item "Interest income" using the effective interest method) and foreign exchange gains and losses (which are included in the line item "Net foreign exchange gain (loss)").

c) *Financial assets held for trading*

Financial assets held for trading are financial assets acquired principally for the purpose of selling or repurchasing in the near term, or for holding as part of a portfolio that is managed together for short-term profit or position taking. Financial assets held for trading consist of bonds and debt instruments, shares and equity instruments, and derivatives with positive fair value which are not designated as hedging instruments.

Financial assets held for trading are initially recognised and subsequently measured at fair value in the statement of financial position, with transaction costs recognised immediately in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest earned which is recognised in the line item "Interest income" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

d) *Financial assets classified as available for sale*

Financial assets classified as available for sale are non-derivative investments which the Group designates as such or are not classified as loans and receivables, financial assets held for trading or financial assets designated at fair value through profit or loss. Financial assets classified as available for sale consist of equity instruments held by the Group for long-term investment purposes.

Financial assets classified as available for sale are initially recognised at fair value plus transaction costs, and subsequently are carried at fair value. Changes in fair value are initially recognised directly in "Other comprehensive income, net of income taxes". The cumulative changes in fair value recognised in "Other comprehensive income" are transferred to the profit and loss in line item "Net financial income" when the financial assets are derecognised or impaired. Gains and losses on derecognition are determined using the average cost method.

86.4. Financial liabilities

For the purpose of measuring its financial liabilities, the Group classifies them at inception in one of the following categories (see also Note 7), except for financial guarantees (see Note 86.15) and loan commitments (see Note 86.16):

• Financial liabilities held for trading; or
• Derivative liabilities held for hedging; or
• Financial liabilities measured at amortised cost.

The Group does not designate financial liabilities as at fair value through profit or loss.

a) *Financial liabilities held for trading*

Financial liabilities held for trading are financial liabilities incurred principally for the purpose of generating profits from short-term price fluctuations or from the dealer's margin. Financial liabilities held for trading consist of short positions in listed bonds and derivatives with negative fair value which are not classified as financial guarantees or are not designated as hedging instruments.

Financial liabilities held for trading are initially recognised and subsequently measured at fair value in the statement of financial position with transaction costs recognised directly in profit or loss. Changes in fair value are recognised in profit or loss in the line item "Net financial income (expense)", except for interest incurred, which is recognised as "Interest expense" on an accrual basis and foreign exchange gains and losses which are included in the line item "Net foreign exchange gain (loss)".

b) *Derivative liabilities held for hedging*

Derivative liabilities held for hedging consist of derivatives with negative fair value which are designated and accounted for as hedging instruments (see Note 86.9).

86.4. Cont'd

c) *Financial liabilities measured at amortised cost*

Financial liabilities measured at amortised cost are non-derivative financial liabilities which are not classified by the Group as financial liabilities held for trading. Financial liabilities measured at amortised cost include deposits, debt issued and other borrowed funds and subordinated loans.

Financial liabilities measured at amortised cost are recognised initially at fair value net of transaction costs incurred, and subsequently are carried at amortised cost using the effective interest method. Amortised cost is calculated by taking into account the amount at which the financial liabilities are measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount (such as due to discounts or premiums and fees and costs that are an integral part of the effective interest rate). Accrued interest is included in the carrying amount of the liabilities in the statement of financial position.

The amortised cost of certain bonds issued by the Group, which are designated as hedged items in qualifying fair value hedge relationships, is adjusted for changes in the fair value of the bonds attributable to interest rate risk (see Note 86.9).

86.5. Determination of fair value of financial assets and financial liabilities

A number of the Group's accounting policies and disclosures require the determination of fair value for measurement and/or disclosure purposes. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price).

When available, the Group measures the fair value of financial assets and financial liabilities using quoted prices in an active market for that instrument. A market is considered active if quoted prices are readily and regularly available and those prices represent actual and regularly occurring transactions. The fair value is based on the most recent observed market prices at the balance sheet date. For all other financial instruments, the Group determines fair value using valuation techniques.

The best evidence of the fair value of a financial instrument at initial recognition is the transaction price unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e. without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets. When such evidence exists, the Group recognises the difference between the transaction price and fair value in profit or loss in the line item Net financial income (expense) on initial recognition of the financial instrument. In cases where the Group relies on data which is not from observable markets, the difference between the transaction price and the value produced by the valuation technique, if any, is recognised in profit or loss in the line item "Net financial income (expense)", depending upon individual facts and circumstances of each transaction and not later than when the data becomes observable or when the instrument is redeemed, transferred or sold.

a) *Valuation models*

The Group measures fair values using a fair value hierarchy, which reflects the significance of the inputs used in making the measurements. Further discussion on the fair value hierarchy can be found in Note 8.

If a market for a financial instrument is not active, the Group establishes its fair value using a valuation technique. The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date. Valuation techniques incorporate all factors that market participants would consider in setting a price and are consistent with accepted methodologies for pricing financial instruments. Valuation techniques include net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes option pricing models and other valuation models. Assumptions and inputs used in valuation techniques include risk-free and benchmark interest rates, credit spreads and other premia used in estimating discount rates, bond and equity prices, foreign currency exchange rates, equity and equity index prices and expected price volatilities and correlations. Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group entity and the counterparty where appropriate. Periodically, the Group calibrates the valuation techniques and tests them for validity using prices from observable current market transactions for the same instrument, without modification or repackaging, or based on other available observable market data.

The Group uses widely recognised valuation models for determining the fair value of common and more simple financial instruments, such as interest rate and currency swaps that use only observable market data and require little management judgement and estimation. Observable prices or model inputs are usually available in the market for listed debt and equity securities, exchange-traded derivatives and simple over-the-counter derivatives such as interest rate swaps. Availability of observable market prices and model inputs reduces the need for management judgement and estimation and also reduces the uncertainty associated with determining fair values. Availability of observable market prices and inputs varies depending on the products and markets and is prone to changes based on specific events and general conditions in the financial markets.

For more complex financial instruments, the Group 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, in which case the inputs are derived from market prices or rates or estimated based on assumptions. The value produced by a model or other valuation technique is adjusted to allow for a number of factors as appropriate, to allow for model risks, bid-ask spreads, liquidity risks, as well as other factors, to the extent that the Group believes a third-party market participant would take them into account in pricing a transaction.

86.5. Cont'd

Management judgement and estimation are usually required for selection of the appropriate valuation model to be used, determination of expected future cash flows of the financial instrument being valued, determination of the probability of counterparty default and prepayments and selection of appropriate discount rates.

Fair values reflect the credit risk of the instrument and include adjustments to take account of the credit risk of the Group and the counterparty where appropriate. For measuring derivatives that might change classification from being an asset to a liability or vice versa such as interest rate swaps, fair values take into account both credit valuation adjustment (CVA) and debit valuation adjustment (DVA) when market participants take this into consideration in pricing the derivatives.

Model inputs and values are calibrated against historical data and published forecasts and, where possible, against current or recent observed transactions in different instruments and against broker quotes. This calibration process is inherently subjective and it yields ranges of possible inputs and estimates of fair value, and management judgement is required to select the most appropriate point in the range.

b) Valuation framework

The Group has an established control framework with respect to the measurement of fair values. The business unit owning the positions is responsible for their valuations and for submitting the valuation to the Bank's Investment Committee for approval. Risk Management provides an independent review of the results, the valuation methods used and of the use of significant unobservable inputs. The final decision on the validity of the valuation is in the hands of the Bank's Investment Committee.

86.6. Recognition and derecognition of financial assets and financial liabilities

The Group uses trade date accounting to recognise purchases and sales of financial assets, i.e. they are recognised on the date on which the Group commits to purchase or sell the asset, except for loans, which are recognised on the date when cash is advanced by the Group to the borrowers. For a financial asset purchased, the Group recognises on the trade date a financial asset to be received and a financial liability to pay. For a financial asset sold, the Group derecognises the asset on the trade date, recognises any gains or losses on disposal and recognises a receivable from the buyer.

The Group recognises financial liabilities held for trading on the trade date, i.e. on the date at which the Group becomes a party to the contractual provisions of the financial instrument. The Group recognises financial liabilities measured at amortised cost on the date when they originated. The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

The Group derecognises financial assets in the following circumstances:
• When the contractual rights to the cash flows from the financial assets expire, or
• When the Group transfers the rights to receive the contractual cash flows on the financial asset in a transaction in which:
- The Group transfers substantially all the risks and rewards of ownership of the financial assets, or
- The Group neither transfers nor retains substantially all the risks and rewards of ownership of the financial assets and it does not retain control of the financial assets.

Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability. On derecognition of a financial asset, the difference between the carrying amount of the asset (or the carrying amount allocated to the portion of the asset transferred), and the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income is recognised in profit or loss.

The Group enters into transactions whereby it transfers assets recognised in its statement of financial position, but retains either all or substantially all risks and rewards of the transferred assets or a portion of them. If all or substantially all risks and rewards are retained, then the transferred assets are not derecognised from the statement of financial position of the Group. Transfers of assets with retention of all or substantially all risks and rewards include, for example, repurchase transactions and securities lending.

The Group does not derecognise from its statement of financial position securities which the Group sells under agreements to repurchase at a specified future date ("repos") at a fixed price or at the sale price plus a lender's return. The Group recognises the cash received as a liability in its statement of financial position. The difference between the sale and repurchase prices is recognised as interest expense over the life of the agreement using the effective interest method.

Securities lending and borrowing transactions are usually collateralised by securities or cash. The transfer of securities to counterparties is only reflected in the statement of financial position if the risks and rewards of ownership are also transferred. Cash advanced or received as collateral is recorded as an asset or liability.

In transactions in which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset.

Substantial modifications of terms of existing financial assets, or replacements with new ones with significantly different terms, result in the Group derecognising the original financial assets and recognising new financial assets at fair value. See also Note 86.28 with respect to renegotiated loans.

86.7. Offsetting financial assets and financial liabilities

Financial assets and liabilities are offset and the net amount presented in the consolidated statement of financial position when, and only when, the Group has a legal right to set off the amounts and it intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

86.8. Derivative financial instruments

Derivatives entered into by the Group may be in the form of stand-alone contracts or embedded in other contracts, in which case the Group assesses whether it is required to separate and account for the embedded derivatives as if they were stand-alone contracts. That would be the case when the economic characteristics and risks of the embedded derivatives are not closely related to the economic characteristics and risks of the host contracts; stand-alone contracts with the same terms as the embedded derivatives would meet the definition of a derivative for accounting purposes; and the combined contracts are not classified by the Group as financial assets or financial liabilities held for trading or designated by the Group as at fair value through profit or loss.

Derivatives which do not classify as equity instruments of the Group are classified as financial assets or financial liabilities, measured at fair value and presented in the statement of financial position in separate line items as assets or liabilities, depending on whether their fair value at the reporting date is positive (assets) or negative (liabilities). When the Group is required to separate and account for embedded derivatives as if they were stand-alone contracts, the Group presents the fair value of the embedded derivatives in the statement of financial position in the same line items in which the Group presents the related host contracts.

The Group applied hedge accounting in the course of the fourth quarter 2016 but not during the comparative period. Accordingly, some of the Group's derivative financial assets and liabilities are accounted for as financial assets or financial liabilities held for trading while others are accounted for as derivative assets or liabilities held for hedging (Note 86.4(b)).

86.9. Fair value hedge accounting

Over the course of the fourth quarter of 2016 the Group started applying fair value hedge accounting with respect to designated hedging relationships consisting of certain fixed-rate euro denominated notes issued by the Bank in 2016 as the hedged items and certain euro denominated interest rate swaps as the hedging instruments, whereby the Group pays floating rate interest and receives fixed rate interest. The hedging relationships are designated and accounted for as fair value hedges because the interest rate swaps are hedging the exposure of the Group to changes in the fair value of the notes arising from changes in interest rates. The Group recognises the changes in the fair value of the interest rate swaps immediately in profit or loss together with the changes in the fair value of the notes which are attributable to the interest rate risk. The changes in the clean fair value of the swaps and the notes are included in the line item “Net financial income (expense)”, the accrued interest on both the notes and the swaps is included in the line item “Interest expense” and foreign exchange gains and losses on the notes are included in the line item "Net foreign exchange gain (loss)").

On initial designation of the hedges, the Group formally documented the relationship between the hedging instruments and hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationships. The Group makes an assessment, both at inception of the hedge relationships and on an ongoing basis, of whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value of the hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within the range of 80–125%.

If a hedging derivative expires or is sold, terminated or exercised, or a hedge no longer meets the criteria for fair value hedge accounting, or the hedge designation is revoked, then hedge accounting for the corresponding hedging relationship is discontinued prospectively. Any adjustment up to the point of discontinuation to a hedged item for which the effective interest method is used is amortised to profit or loss as part of the recalculated effective interest rate of the item over its remaining life.

86.10. Investments in associates

Associates are entities over which the Group has significant influence.

Significant influence is the power to participate in the financial and operating policy decisions of an entity, but is not control or joint control over those policies. If the Group holds 20% or more of the voting power of an entity, it is presumed that the Group has significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the Group holds less than 20% of the voting power of an entity, it is presumed that the Group does not have significant influence, unless such influence can be clearly demonstrated. The Group considers the existence and effect of potential voting rights that are currently exercisable or convertible, including potential voting rights held by other entities, when assessing whether it has significant influence.

The Group accounts for its investments in associates using the equity method. Under the equity method, investments in associates are initially recognised at cost. The carrying amount of each investment is adjusted to recognise changes in the Group's share of net assets of the associate since the acquisition date. Goodwill relating to acquisitions of associates is included in the carrying amount of the investments and is not tested for impairment separately.

86.10. Cont'd

The consolidated financial statements of the Group include the Group's share of the profit or loss and other comprehensive income of associates, from the date that significant influence commences until the date that significant influence ceases. Unrealised gains and losses resulting from transactions between the Group and the associates are eliminated to the extent of the interest in the associate.

When the Group's share of losses of an associate exceeds its interest in the associate, the carrying amount of that associate is reduced to nil and recognition of further losses is discontinued, except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate. If the associate subsequently reports profits, the Group resumes recognising its share of profits only after its share of profits equals the share of losses not recognised.

After application of the equity method, the Group determines whether it is necessary to recognise an impairment loss on its investments in associates. At each reporting date, the Group determines whether there is objective evidence that individual investments in associates are impaired. If there is such evidence, the Group calculates the amount of impairment as the difference between the recoverable amount of the associate and its carrying amount, and recognises the impairment loss in the consolidated income statement.

Upon loss of significant influence over an associate, the Group measures and recognises any retained investment at its fair value. Any difference between the carrying amount of the associate upon loss of significant influence and the fair value of the retained investment and proceeds from disposal is recognised in profit or loss.

86.11. Leases

The Group classifies leases based on the substance of the arrangements and the extent of the transfer of risks and rewards incidental to ownership of leased assets. A lease is classified as an operating lease if the lessor does not transfer substantially all the risks and rewards incidental to ownership. A lease is classified as a finance lease if the lessor transfers substantially all the risks and rewards incidental to ownership.

a) *Group as a lessee*
Lease payments under operating leases where the Group is the lessee are recognised as an expense on a straight-line basis over the capital lease term.

b) *Group as a lessor*
When the Group is the lessor in a capital lease, the Group recognises a capital lease receivable equal to the net investment in the capital lease and presents it in the line item “Loans to customers” in the statement of financial position. The Group applies its accounting policies for derecognition and impairment of loans and receivables also to its capital lease receivables. The Group recognises the finance income from capital lease receivables in profit or loss in the line item “Interest revenue” over the period of the capital lease so as to give a constant periodic rate of return on the net investment in the capital lease.

When the Group is lessor in arrangements which involve the legal form of capital leases, but which in substance do not involve leases, the Group classifies them within loans and receivables.

86.12. Property and equipment

a) *Recognition and measurement*
Items of property and equipment are measured at cost less accumulated depreciation and impairment losses (see Note 86.26).

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 Group 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 Group and the cost of the item can be measured reliably. The decision if subsequent costs are added to the acquisition cost of the property or 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 recognised in profit or loss as incurred.

c) *Depreciation*
Items of property and equipment are depreciated from the date they are available for use, except for land, which is not depreciated. Each part of a depreciable item of property and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. The depreciable amount of each significant item of property and equipment is determined after deducting its residual value. Depreciation is expensed in profit or loss on a straight-line basis over the estimated useful lives of each part of an item of property and equipment. The estimated useful lives for the current and comparative periods of significant items of property and equipment are as follows:

Buildings	50 years
Fixtures	6 - 12 years
Equipment	4 years
Vehicles	3 years

The depreciation method, useful lives and residual values are reviewed at each reporting date and adjusted if appropriate.

86.13. Intangible assets

Software acquired by the Group is measured at cost less accumulated amortisation and impairment losses.

Expenditure on internally developed software is recognised as an asset when the Group is able to demonstrate its intention and ability to complete the development and use the software in a manner that will generate future economic benefits, and can reliably measure the costs to complete the development. The capitalised costs of internally developed software include all costs directly attributable to developing the software and capitalised borrowing costs, and are amortised over its useful life. Internally developed software is stated at capitalised cost less accumulated amortisation and impairment.

Subsequent expenditure on software assets is capitalised only when it increases the future economic benefits embodied in the specific asset to which it relates. All other expenditure is expensed as incurred.

Software is amortised on a straight-line basis in profit or loss over its estimated useful live, from the date that it is available for use. The estimated useful life of software for the current and comparative periods is four to ten years.

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

Non-current assets and disposal groups (comprising groups of assets and liabilities associated with those assets, including non-current assets) are classified as held for sale and presented in separate line items on the face of the statement of financial position if the Group expects to recover their carrying amount principally through a sale transaction rather than through continuing use. For this to be the case, the assets, or disposal groups, must be available for immediate sale in their present condition subject only to terms that are usual and customary for sales of such assets, or disposal groups, and their sale must be highly probable.

Immediately before classification as held for sale, the assets, or components of disposal groups, are remeasured in accordance with applicable IFRSs. Thereafter, the assets, or disposal groups, are measured at the lower of their carrying amount and fair value less costs to sell, except for deferred tax assets, financial assets and investment properties, which are measured in accordance with the accounting policies of the Group applicable to those assets. Once classified as held for sale, intangible assets are no longer amortised, property and equipment is no longer depreciated and investments in associates are no longer equity accounted. Liabilities associated with assets classified as held for sale are measured in accordance with the accounting policies of the Group applicable to those liabilities.

Income earned and expenses incurred on assets and disposal groups held for sale continue to be recognised in the appropriate line items in profit or loss until the transaction is complete. However, income and expenses on assets and liabilities of subsidiaries acquired by the Group exclusively with a view to resale are recognised in profit or loss in the line item “Profit (loss) from discontinued operations, net of income tax” (see Note 86.30).

86.15. Financial guarantees

Financial guarantees are contracts that require the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due, in accordance with the terms of a debt instrument. Financial guarantees are issued by the Group to credit institutions and other parties on behalf of its customers so that they can secure loans, overdrafts and banking facilities. Liabilities arising from financial guarantees issued by the Group are initially measured at their fair value, being the premium received, and the initial fair value is amortised on a straight line basis over the life of the guarantee. The liabilities are subsequently carried at the higher of the unamortised premium and the best estimate of the expenditure required to settle the liability when a payment under the contracts has become probable. The estimates are determined based on experience of similar transactions and history of past losses, supplemented by a judgement by the management.

Any changes in the liabilities arising from financial guarantees is recognised in profit or loss. The premium received is recognised as revenue in profit or loss in the line item "Fee and commission income".

86.16. Loan commitments

Loan commitments are firm commitments of the Group to provide credit under pre-specified terms and conditions. The Group recognises a provision for loan commitments in the statement of financial position, in the line item “Other liabilities”, only when the Group is committed to making a loan that would be considered to be impaired or when the commitment becomes onerous. The related expense is then recognised in profit or loss. Loan commitment fees received by the Group are recognised in accordance with the accounting policy disclosed in Note 86.22.

86.17. Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event, if it is probable that the Group will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation.

The amount recognised as a provision is the best estimate of the consideration required to settle the present obligation at the balance sheet date, taking into account the risks and uncertainties surrounding the obligation. Where a provision is measured using the cash flows estimated to settle the present obligation, its carrying amount is the present value of those cash flows. When some or all of the economic benefits required to settle a provision are expected to be recovered from a third party, the receivable is recognised as an asset if it is virtually certain that the reimbursement will be received and the amount of the receivable can be measured reliably.

The Group recognises a contingent liability assumed in a business combination if it is a present obligation that arises from past events and its fair value can be measured reliably, even if it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

86.18. Employee benefits

All Group entities are required to pay fixed contributions to publicly or privately administered pension plans on a mandatory and contractual basis. The Group has no further payment obligations once these contributions have been paid by the Group. The Group recognises these contributions as salary related expenses when they become due. The Group does not have a defined benefit pension plan.

Short-term employee benefits include salaries, short-term cash bonuses, social security contributions, short-term compensated absences and non-monetary benefits for current employees. Short-term employee benefit obligations are expensed by the Group as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus plans if the Group has a present legal or constructive obligation to pay this amount as a result of past service provided by the employee and the obligation can be estimated reliably.

86.19. Equity

a) *Share capital*

The share capital disclosed in the consolidated financial statement represents the total nominal value of ordinary shares issued by the parent company and outstanding at the reporting date. Incremental costs directly attributable to the issuance of ordinary shares are recognised as a deduction from equity, net of any tax effects.

b) *Dividends on shares*

Dividends payable to shareholders of the parent company are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders in the parent company's annual general meeting. Dividends payable to non-controlling shareholders in subsidiaries are recognised as a liability and deducted from equity in the period in which the dividends are approved by the shareholders' meeting of the subsidiaries. Dividends declared after the reporting date are not recognised as a liability at the reporting date.

c) *Other reserves*

Other reserves consist of statutory reserve, translation reserve and restricted reserves.

i. Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations.

ii. Restricted reserves

In June 2016 the Icelandic Parliament passed a law on changes to the Icelandic Annual Accounts Act. The changes to the act are effective as from 1 January 2016. According to new provisions of the act an entity is to transfer, if applicable, certain amounts from retained earnings to restricted reserves which can therefore not be distributed as dividends to shareholders. These restricted reserves are specified as follows:

Restricted reserve due to capitalised development cost

When the Group capitalises development cost it transfers a corresponding amount from retained earnings to a restricted reserve. In the future the restricted amount is to be transferred back to retained earnings as the capitalised development cost is amortised in profit or loss.

Restricted reserve due to fair value changes of financial assets designated at fair value

The Group transfers fair value changes of a financial asset designated at fair value through profit or loss, net of tax if applicable, from retained earnings to a restricted reserve. Amounts recognised in the reserve are transferred back to retained earnings upon sale of the financial asset.

Restricted reserve due to unrealised profit of subsidiaries and associates

If share of profit of a subsidiary or an associated company is in excess of dividend received or which can be claimed, the Group transfers the difference to a restricted reserve in equity. If the Group's shareholding in a subsidiary or an associate is sold or written off the applicable amount recognised in the reserve is transferred to retained earnings.

Notes to the Consolidated Financial Statements

86.20. Cash and cash equivalents

Cash and cash equivalents in the consolidated statement of cash flows consist of cash on hand, treasury bills, demand and term deposits with the Central Bank and with other credit institutions, short-term loans to credit institutions and other liquid debt securities at floating interest rates. Cash and cash equivalents comprise balances with less than three months maturity from the date of acquisition, that are subject to an insignificant risk of changes in their fair value and which are used by the Group in the management of its short-term cash commitments.

86.21. Interest income and expense

For all financial assets and financial liabilities measured at amortised cost interest income and expense is recognised in profit or loss using the effective interest method. For all financial assets and financial liabilities held for trading and for all financial assets designated at fair value through profit or loss, interest income and expense is recognised through profit or loss on an accrual basis.

Accrued interest on interest rate swaps, which are designated and accounted for as hedging instruments in fair value hedges of the interest rate risk arising from certain fixed-rate euro denominated bonds issued by the Group (see Note 86.9), is recognised in profit or loss as an adjustment to the interest expense recognised for the bonds.

The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, when appropriate, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group estimates cash flows, considering all contractual terms of the financial instrument, but does not consider future credit losses. The calculation generally includes all fees and amounts paid or received between parties to the contract that are an integral part of the effective interest rate, as well as transaction costs and all other premiums or discounts.

The effective interest rate is established on initial recognition of financial assets and financial liabilities and their carrying amount is subsequently adjusted if the Group revises its estimates of payments or receipts. The adjusted carrying amount is calculated based on the original effective interest rate (i.e. the effective interest rate established at initial recognition) and the change in carrying amount is recorded as interest income or expense. For floating rate instruments, interest income or expense is generally recognised based on the current market rate plus or minus amortisation or accretion of the discount or premium based on the original effective interest rate. Interest on impaired financial assets is calculated by applying the original effective interest rate of the financial asset to the carrying amount as reduced by any allowance for impairment.

Interest income and expense include gains and losses on derecognition of loans and receivables and financial liabilities measured at amortised cost.

86.22. Net fee and commission income

Net fee and commission income comprises fees and commission income and expenses. Fees and commissions are generally recognised on an accrual basis when the service has been provided. Fees and commission income and expense that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

Loan commitment fees for loans that are likely to be drawn down are deferred and recognised as an adjustment to the effective interest rate of the loan. When a loan commitment is not expected to result in the draw-down of a loan, loan commitment fees are recognised in profit or loss on a straight-line basis over the commitment period.

Loan syndication fees are recognised as revenue in profit or loss when the syndication has been completed and the Group has retained no part of the loan package for itself or has retained a part at the same effective interest rate as the other participants.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party, such as the arrangement of the acquisition of shares or other securities or the purchase or sale of businesses, are recognised on completion of the underlying transaction.

Portfolio and other management advisory and service fees are recognised based on the applicable service contracts, usually on a time-apportionate basis.

Asset management fees related to investment funds are recognised rateably over the period in which the service is provided. The same principle is applied for wealth management, financial planning and custody services that are continuously provided over an extended period of time. Performance-linked fees or fee components are recognised when the performance criteria is fulfilled.

Notes to the Consolidated Financial Statements

86.23. Net financial income (expense)

Net financial income (expense) consist of net gain (loss) on financial assets and liabilities held for trading, net gain (loss) on financial assets designated at fair value through profit or loss, net gain (loss) on fair value hedges, net gain (loss) on financial assets classified as available for sale and net gain (loss) of interest in associates.

a) *Net gain (loss) on financial assets and liabilities held for trading*

Net gain (loss) on financial assets and liabilities held for trading includes all realised and unrealised fair value changes of financial assets and liabilities classified by the Group as held for trading, except for interest income and interest expense (which are included in the line items “Interest income” and “Interest expense”, (see Note 86.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, (see Note 86.24). Dividend income from financial assets held for trading is recognised in profit or loss when the Group's right to receive payment is established.

Changes in fair value of derivatives that are classified as held for trading but which are economic hedges of financial assets designated at fair value through profit or loss are presented in the bonds to the consolidated financial statements as an offset to net gains on financial assets designated at fair value through profit or loss.

b) *Net gain (loss) on financial assets designated at fair value through profit or loss*

Net gain (loss) on financial assets designated at fair value through profit or loss includes all realised and unrealised fair value changes of financial assets designated by the Group as at fair value through profit or loss, except for interest income and interest expense (which are included in the line items “Interest income” and “Interest expense”, see Note 86.21) and foreign exchange gains and losses (which are included in the line item “Net foreign exchange gain (loss)”, see Note 86.24). Dividend income from financial assets designated at fair value through profit or loss is recognised in profit or loss when the Group's right to receive payment is established.

Net gain on financial assets designated at fair value through profit or loss also include changes in fair value of derivatives that are classified by the Group as held for trading but which are economic hedges of financial assets designated by the Group as at fair value through profit or loss.

c) *Net gain (loss) on fair value hedges*

Net gain (loss) on fair value hedges includes the changes in the clean fair value of interest rate swaps which are designated and accounted for as hedging instruments in fair value hedges and the changes in the fair value of certain bonds issued by the Group, which are attributable to the interest rate risk of the bonds (see Note 86.9).

d) *Net gain (loss) on financial assets classified as available for sale*

Net gain (loss) on financial assets classified as available for sale consist of cumulative changes in fair value transferred to profit or loss upon derecognition or impairment as well as dividend income. Dividends are recognised in profit or loss when the Group's right to receive payment is established.

86.24. Net foreign exchange gain (loss)

Net foreign exchange gain (loss) disclosed as a separate line item in the income statement comprises all foreign exchange differences arising on the settlement of foreign currency monetary assets and liabilities and on translating foreign currency monetary assets and liabilities at rates different from those at which they were translated on initial recognition during the period or in previous financial statements.

Net foreign exchange gain (loss) also includes foreign exchange differences arising on translating non-monetary assets and liabilities which are measured by the Group at fair value in foreign currencies and whose other gains and losses are also recognised in profit or loss.

86.25. Administrative expenses

Administrative expenses consist of salaries and related expenses, depreciation of property and equipment, amortisation of intangible assets and other administrative expenses, such as housing costs, advertising expenses and information system related expenses.

86.26. Impairment of non-financial assets

The carrying amounts of the Group's non-financial assets, other than deferred tax assets, are reviewed at each reporting date to determine whether there is any indication of impairment. If any such indication exists, then the asset's recoverable amount is estimated.

An impairment loss for non-financial assets is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset's carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortisation, if no impairment loss had been recognised.

86.27. Bank tax

Bank tax is a tax on credit institutions which stated purpose is to create revenue for the Icelandic government to meet increased costs attributable to the insolvency of the Icelandic banks in October 2008. Furthermore, the tax is intended as a deterrent to increased risk appetite. Following the Icelandic governments debt relief initiatives introduced in 2013, the bank tax rate was set at 0.376% of total liabilities in excess of ISK 50,000 million effective from 1 January 2013. The Bank tax is shown in a separate line in the income statement.

86.28. Net loan impairment

Net loan impairment is the net amount recognised in profit or loss following a revision of estimates of receipts from loans and receivables. It is made up of income due to revision of estimated future cash flows and expenses due to individually and collectively assessed impairment losses on loans and receivables.

At each reporting date, the Group assesses the current status of loans and receivables and whether there is any objective evidence of changes in expected cash flows, for example due to differences in estimated and actual payments, changes in the value of collaterals and improvement in the financial situation of debtors. 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 or acquired, the previously recognised impairment loss is reversed. The amount of any reversal is recognised in profit or loss in the line item “Net loan impairment”.

a) *Impairment charges*

A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognised.

Impairment of loans and receivables

If there is objective evidence that an impairment loss has been incurred on loans and receivables, their carrying amount is reduced through the use of an allowance account to the present value of expected future cash flows, discounted at their original effective interest rate.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss include:
• Delinquency in contractual payments of principal or interest;
• Cash flow difficulties experienced by the borrower;
• Breach of loan covenants or conditions;
• Initiation of bankruptcy proceedings;
• Deterioration of the customer's competitive position;
• Deterioration in the value of collateral;
• Downgrading of an asset;
• Restructuring and forbearance.

The Group's management assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Loans and receivables that are not impaired individually become a part of a portfolio which is assessed for impairment. Collective assessment based on a portfolio assumes that loans and receivables have similar credit risk characteristics.

Interest income on impaired loans and receivables is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring impairment losses.

Calculation of recoverable amount

The recoverable amount of the Group's loans and receivables is calculated as the present value of estimated future cash flows. The discount rate used for fixed rate loans and receivables is the effective interest rate computed at initial recognition. For variable rate loans and receivables the discount rate is the current effective interest rate.

Loan write-offs

When a loan is uncollectible, it is written-off against the related allowance for impairment. Such loans are written-off after all the necessary procedures have been completed and the amount of the loss has been determined.

Reversals of impairment

An impairment loss in respect of loans and receivables is reversed if the subsequent increase in recoverable amount can be related objectively to an event occurring after the impairment loss was recognised.

86.28. Cont'd

If the Group revises its estimate of payments or receipts, the Group adjusts the carrying amount of the loans and receivables, to reflect actual and revised estimated cash flows. If there is any change in expected cash flows, the Group recalculates the carrying amount of these loans and receivables as the present value of the revised estimated future cash flows, using their effective interest rate method. The difference between the revised carrying amount of the loans and their current carrying amount, which includes accrued interest, indexation, foreign exchange differences and actual payments received by the Group, is recognised in profit or loss in the line item “Net loan impairment”. Upwards changes in estimated future cash flows are first recognised as a reversal of previously recognised impairment losses.

Renegotiated loans

Where possible, the Group seeks to restructure loans rather than to take possession of collateral. This may involve extending the payment arrangements and the agreement of new loan conditions. Once the terms have been renegotiated, the loan is no longer considered past due. The loans continue to be subject to an individual or collective impairment assessment.

Allowance for collective impairment

Allowance for collective impairment losses reflects estimates of impairment losses that have been incurred but not identified in the reporting period for a group of loans that have similar credit risk characteristics.

86.29. Income tax

Income tax, disclosed as a separate line item in the income statement comprises current and deferred tax from continuing operations, excluding the Group's share of income tax of the Group's equity-accounted associates. Income tax from discontinued operations is included in the line item “Profit (loss) from discontinued operations, net of income tax” in the income statement (see Note 86.30).

Income tax is recognised in profit or loss, except to the extent that it relates to items recognised in other comprehensive income or directly in equity, in which case the Group recognises it in other comprehensive income or directly in equity, consistent with the recognition of the underlying item to which it relates.

Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantially enacted at the reporting date, and any adjustment to tax payable in respect of previous years.

Deferred tax is calculated based on temporary differences between the carrying amounts of assets and liabilities as presented in the tax return on the one hand, and in the consolidated financial statements on the other, taking into consideration any tax loss carry forwards. This difference is due to the fact that tax assessments are based on premises that differ from those governing the financial statements, mostly because revenues, especially of financial assets, are recognised earlier in the financial statements than in the tax return.

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 Deferred tax is measured at the tax rates that are expected to be applied to temporary differences when they reverse, using tax rates enacted or substantially enacted at the reporting date.

Tax assets are included in line items „Other assets“ and deferred tax liabilities are included in line items „Tax liabilites“ in the statement of financial position. However, tax assets and tax liabilities that are part of disposal groups held for sale (see Note 86.14) are included in the line items “Non-current assets and disposal groups held for sale“ and „Non-current liabilities and disposal groups held for sale“, respectively, in the statement of financial position.

Current tax assets and current tax liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets and liabilities are offset in the statement of financial position if the Group has a legally enforceable right to set off current tax assets against current tax liabilities, and the deferred tax assets and the deferred tax liabilities relate to taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

86.30. Discontinued operations

The Group presents in a separate line in the income statement the profit or loss from discontinued operations, net of income tax. Discontinued operations consist of subsidiaries acquired by the Group exclusively with a view to resale that meet the criteria to be classified as held for sale (see Note 86.14) from acquisition date.

The profit or loss from discontinued operations consists of (a) the post-tax profit or loss of the subsidiaries acquired by the Group exclusively with a view to resale, (b) the post-tax gain or loss recognised on the measurement to fair value less costs to sell and on the disposal of the subsidiaries acquired by the Group exclusively with a view to resale and (c) the post-tax profit or loss from the sale of foreclosed assets held for sale.

86.31. Offsetting income and expenses

The Group presents income and expenses on a net basis in the income statement only when required or permitted under IFRSs.

86.32. Earnings per share

The Group presents basic and diluted earnings per share (EPS) for its ordinary shares. Basic EPS are calculated by dividing the profit or loss attributable to ordinary shareholders of the Group by the weighted average number of ordinary shares outstanding during the period. Diluted EPS are determined by adjusting the profit or loss attributable to ordinary shareholders and the weighted average number of ordinary shares outstanding for the effects of all dilutive potential ordinary shares, if any.

86.33. Segment reporting

An operating segments is a distinguishable component of the Group that engages in business activities from which it may earn revenues and incur expenses, including revenues and expenses that relate to transactions with any of the Group's other components. Each operating segments is engaged in providing products or services which are subject to risk and return that are different from those of other operating segments. The segment profit presented is the profit reported to the chief operating decision maker (CEO) and the Board of Directors for the purpose of resource allocation and assessment of segment performance.

86.34. Initial application of new IFRS standards and amendments to standards

The new IFRS standards and amendments to standards which became effective from 1 January 2016 did not have a material impact on the Group's consolidated financial statements.

86.35. New IFRS standards and amendments to standards issued but not yet effective

A number of new IFRS standards and amendments to standards have been issued but are not yet effective. The Group did not early adopt any of them and intends to adopt them when they become effective. Of all new IFRS standards and amendments to standards issued but not yet effective, the Group expects only the following ones to have an impact on its consolidated financial statements in the period of their initial application:

a) *IFRS 9 Financial Instruments*

IFRS 9 Financial Instruments replaces the existing rules in IAS 39 Financial Instruments: Recognition and Measurement, and introduces consequential amendments to other standards, such as IAS 1 Presentation of Financial Statements and IFRS 7 Financial Instruments: Disclosures. The key features of IFRS 9 are the following:

• Financial assets are required to be classified into one of three measurement categories, i.e. measured subsequently at amortised cost, measured subsequently at fair value through other comprehensive income or measured subsequently at fair value through profit or loss. The assessment as to how an asset should be classified is to be made at initial recognition. Reclassification between measurement categories is required if the objective of the business model in which the financial assets are held changes after initial recognition and if the change is significant to the entity's operations.

• A financial asset is classified as being subsequently measured at amortised cost if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held within a business model whose objective is to collect contractual cash flows.

• A financial asset is classified as being subsequently measured at fair value through other comprehensive income if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest and the asset is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

• All other financial assets are classified as being subsequently measured at fair value through profit or loss. In addition, there is an option at initial recognition to irrevocably designate a financial asset as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.

• All investments in equity instruments are to be measured subsequently at fair value. Equity instruments that are held for trading will be measured at fair value through profit or loss. For all other investments in equity instruments, an irrevocable election can be made at initial recognition, to recognise unrealised and realised fair value gains and losses, including any related foreign exchange component, in other comprehensive income rather than profit or loss. For such investments there will be no recycling of fair value gains and losses to profit or loss. This election may be made on an instrument-by-instrument basis. Dividends are to be presented in profit or loss, as long as they represent a return on investment.

• IFRS 9 retains the existing requirements in IAS 39 for embedded derivatives where the host is not a financial asset in the scope of IFRS 9, e.g. a financial liability or a lease receivable. However, derivatives embedded in financial assets that are within the scope of IFRS 9 are not to be separated. Instead, the whole hybrid financial instrument is to be assessed for classification in its entirety.

• IFRS 9 retains the existing requirements in IAS 39 for the classification of financial liabilities. For financial liabilities designated at fair value through profit or loss, the amount of change in fair value attributable to changes in the credit risk of those liabilities must, in general, be presented in other comprehensive income, with only the remaining amount of the total gain or loss being included in profit or loss. The amounts presented in other comprehensive income may not be subsequently reclassified to profit or loss but may be transferred within equity.

86.35. Cont'd

However, if the recognition of gains and losses in other comprehensive income creates or enlarges an accounting mismatch in profit or loss, then the whole fair value change must be presented in profit or loss. Additionally, all fair value gains and losses continue to be included in profit or loss for loan commitments and financial guarantee contracts designated as fair value through profit or loss.

• IFRS 9 replaces the incurred loss model in IAS 39 with an expected credit loss model for calculating impairment on financial assets. The expected credit loss model in IFRS 9 will not apply to investments in equity instruments and financial assets classified as being subsequently measured at fair value through profit or loss. The expected credit loss model in IFRS 9 uses a dual measurement approach, under which the loss allowance for expected credit losses is measured at each reporting date as either 12-month expected credit losses or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk of the financial instrument since initial recognition. Special rules will apply to financial assets that are credit-impaired at initial recognition.

• IFRS 9 includes a new general hedge accounting model, which aligns hedge accounting more closely with risk management. The new model does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness under IAS 39. However, under the new model more hedging strategies that are used for risk management may qualify for hedge accounting. In addition, the effectiveness test has been overhauled and replaced with the principle of economic relationship. Retrospective assessment of hedge effectiveness will also no longer be required. IFRS 9 carries forward guidance from IAS 39 on portfolio fair value hedges of interest rate risk and also allows entities to continue to apply all of the hedging requirements in IAS 39 rather than applying the new general hedge accounting model. The Group has not decided whether to continue to apply hedge accounting under IAS 39 or apply hedge accounting according to IFRS 9.

• IFRS 9 introduces new presentation requirements and extensive new and amended disclosure requirements, including requirements for disclosures about transition from IAS 39 to IFRS 9.

IFRS 9 will become mandatory for the Group starting with its consolidated financial statements for the year 2018, with retrospective application generally required but subject to specific exceptions. The Group has initiated a formal implementation project to ensure it will be ready for parallel run in 2017 and application from 1 January 2018. In 2015 the Group set up a multidisciplinary implementation team with members from its Risk, Finance and Operations teams to prepare for IFRS 9 implementation. The Project is sponsored by the Chief Financial Officer, Chief Risk Officer and Chief Operating Officer, who regularly report to the Group's Audit Committee. The Project has individual work streams, business model and classification of financial assets, impairment & valuation models, internal & external financial reporting, investor relations and solution implementation. The initial assessment and analysis stage was completed in 2016 for all work streams. Both the classification and measurement and impairment sub-teams have now finished the analysis and design phases and have assessed the corresponding disclosure requirements.

The Group is currently designing and implementing the necessary changes to definitions, systems and processes to adopt the three stage expected credit loss model. As part of the IFRS 9 implementation, the Group is also reviewing the impairment process. It will be more costly for the Group to have loans with a significant increase in credit risk in stage 2 compared to the general impairment of IAS 39, but in stage 3 the impairment allowance might actually decrease with the usage of probability-weighted average of credit losses. Due to the complexity of the standard and a number of unsolved issues, the Group does not have a full overview of the total impact on impairment charges yet. The development of the new impairment process is expected to continue until the implementation in 2018.

b) IFRS 15 Revenue from Contracts with Customers

The IASB published the new standard, IFRS 15 “Revenue from Contracts with Customers” in 2014. Clarifications to the standard were published in April 2016. The new standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition standards and interpretations within IFRS, such as IAS 18 “Revenue”. The new standard is effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. The standard was endorsed by the EU-commission in 2016 and the clarifications are expected to be endorsed in 2017. The Group does not currently intend to early adopt the standard. The standard does not apply to financial instruments, or lease contracts. The Group has not finalised the investigation of the impact on the consolidated financial statements but the current assessment is that the new standard will not have any significant impact on the consolidated financial statements, capital adequacy, or large exposures in the period of initial application.

c) IFRS 16 Leases

The IASB has published the new standard, IFRS 16 “Leases”. The adoption of the new standard will result in minor changes to the financial reporting of lessors. The new standard changes the accounting requirements for lessees. All leases (except for short term- and small ticket leases) should be accounted for on the balance sheet of the lessee as a right to use the asset and a corresponding liability, and the lease payments should be recognised as amortisation and interest expense. The new standard is effective for annual periods beginning on or after 1 January 2019 and earlier application is permitted. The amendments are expected to be endorsed by the EU-commission in 2017. The Group does not currently intend to early adopt the standard and work is currently under way on assessing the standard's impact on the consolidated financial statements.

d) IAS 7 Statement of Cash Flows

In January 2016, the IASB issued amendments to IAS 7 “Statement of Cash Flows” with the intention to improve disclosures of financing activities and help users to better understand the reporting entities' liquidity positions. Under the new requirements, entities will need to disclose changes in their financial liabilities as a result of financing activities such as changes form cash flows and non-cash items (e.g. gains and losses due to foreign currency movements). The amendment is effective from 1 January 2017. The Group is currently evaluating the impact.

Unaudited Appendix: Corporate Governance Statement 2016

The Board of Directors of Íslandsbanki is committed to excellence in corporate governance complying with the applicable regulatory standards and best international practices in the field of corporate governance.

Íslandsbanki's governance practises are consistent with general corporate governance guidelines for entities regulated by official supervisors and regulatory instruments. The regulatory framework for corporate governance practices within Íslandsbanki consists of the law applicable to entities subject to the supervision of the Financial Supervisory Authority (FME) as well as other applicable law and regulations, including those imposed by the FME and Nasdaq Iceland, available at their respective websites (www.fme.is and www.nasdaqomxnordic.com). The applicable law includes, inter alia, the Act on Financial Undertakings no. 161/2002, the Act on Securities Transactions no. 108/2007, the Act on Competition no. 44/2005 and the Act on Public Limited Companies no. 2/1995, which along with the Íslandsbanki's Articles of Association lay the foundation for the Bank's existence and activities. The relevant law is available on the Icelandic legislature's website (www.althingi.is).

Exemplary in Corporate Governance

Íslandsbanki is committed to maintaining high standards of governance complying with best governance practices. Íslandsbanki was first recognized as "Exemplary in Corporate Governance" in March 2014 by the Center of Corporate Governance at the Institute for Business Research, University of Iceland. The recognition was awarded following a comprehensive review of the practices of the Board, Board subcommittees and management. The recognition was renewed in March 2015 and 2016 and again in February 2017.

Íslandsbanki maintains a Good Governance Policy, the Decision Making Matrix, which outlines all major decisions the Bank may wish to take under given circumstances. The policy is a part of the Bank's effort to improve its material actions and enhance stakeholders' trust. The Decision Making Matrix sets specific conditions to all major decision-making. Furthermore, it sets the requirement that all such decisions are taken after consultation with the relevant parties within the Bank and on the basis of the best information available at the time.

Compliance with Corporate Governance Guidelines

In accordance with Paragraph 7 of Article 54 of the Act on Financial Undertakings no. 161/2002, the Bank is required to comply with accepted guidelines on the governance of financial undertakings. The Board of Directors follows the Corporate Governance Guidelines (5th ed.) issued by the Iceland Chamber of Commerce, Nasdaq Iceland and SA-Business Iceland (hereinafter the Guidelines). The Guidelines are available on www.corporategovernance.is. Governance practices of the Bank are consistent with the Guidelines. Íslandsbanki complies with them in all respects except for certain items in Articles 1.5 and 2.9. The following discussion explains the reasons behind these exceptions as well as measures taken in relation to them.

In accordance with Article 1.5 of the Guidelines the shareholders' meeting shall appoint members to a nomination committee or decide how they should be appointed. The Bank's shareholders, as well as the Board, have not deemed it necessary to appoint a nomination committee at this time given the ownership of the Bank. Candidates for board membership are nominated by the Icelandic Government, sole owner of the Bank, through a selection process administered by Icelandic State Financial Investments (ISFI) in accordance with article 7 of the Act no. 88/2009 on the Icelandic State Financial Investments (ISFI Act).

According to Article 2.9 of the Guidelines it is preferred that the Board sets a policy of social responsibility and a code of ethics. The Executive Board of the Bank adopted a code of conduct for the Bank in January 2011, which all employees were involved in formulating. The Board will be adopting a new code of ethics in the year 2017.

Main aspects of Risk Management and Internal Control

Internal Control

The risk management and internal control framework of the Bank is based on the three-lines-of-defence model, as referred to in the European Banking Authority's Guidelines on Internal Governance, and aims for informed decision-making and strong risk awareness throughout the Bank. The framework is intended to ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported internally and externally, and compliance with laws, regulations, supervisory requirements and the Bank's internal rules.

The first line of defence consists of the Bank´s business and support units; the second line of defence is comprised of the Bank´s internal control units, Risk Management and Compliance; and the third line of defence is Internal Audit which keeps the Board and management informed of the quality of corporate governance, risk management and internal controls, including by performing independent and objective audits.

Risk Management

The Board of Directors has a supervising role monitoring the execution of set policies, the sound control of accounting and financial management and ensures that group internal audit, compliance and risk management are effective at all times.

The management committees: The Executive Board; Risk Committee; Asset and Liability Committee; and Investment Committee, are responsible for implementing risk management practises and internal monitoring in accordance with Board authorisation. Under this authorisation, these committees issue detailed guidelines for risk assessment and individual risk thresholds in accordance with the Bank's defined risk appetite.

Unaudited Appendix: Corporate Governance Statement 2016

Further information on the Bank's risk management structure and internal control can be found in the Bank's annual Pillar 3 Report which is published on the Bank's website.

Audit and accounting

The CEO ensures that Directors of the Board are provided with accurate information on the Bank's finances, development and operations on a regular basis.

The Bank's Finance division is responsible for the preparation of the Bank's consolidated financial statements in line with the International Financial Reporting Standards (IFRS). The Board's Audit Committee gives its opinion on annual and interim consolidated financial statements before their submission for Board approval and endorsement. Management reporting is generally presented to the Board 10 times a year. The external auditors review and audit annual consolidated financial statements. An evaluation of weaknesses in the Bank's internal controls in relation to the accounting process is included in the external auditors report to the Boards Audit Committee.

The consolidated financial statements are published on an annual and quarterly basis. The Risk management notes to the consolidated financial statements form part of the accounting process, see further notes 58-83 of the consolidated financial statements.

As is provided for in the Act on Financial Undertakings and the Bank's Articles of Association, the Bank's external audit firm is elected at the AGM for a term of five years. At the 2016 AGM the Icelandic National Audit Office (INAO) was elected to serve as Íslandsbanki's independent external auditing firm, in accordance with Article 6(2) of Act no. 86/1997 on the Icelandic National Audit Office. The INAO has concluded an agreement and trusting Ernst & Young ehf. with carrying out the Bank's external audit on its behalf.

Group Internal Audit

Group Internal Audit operates independently from other departments in accordance with Article 16 of the Act on Financial Undertakings no. 161/2002. The department provides Íslandsbanki with independent, objective, assurance over the effectiveness of risk management, control and governance processes. The Chief Audit Executive is engaged by the Board and is responsible for internal audit on a group basis.

Compliance Officer

As a financial undertaking licensed to conduct securities trading and an issuer of listed financial instruments, Íslandsbanki operates a compliance department. The Bank's Compliance Officer is engaged by the CEO, subject to Board confirmation, conferring the department's mandate. The Compliance officer maintains an independent position within the Bank's organisation and is responsible for monitoring and assessing regularly whether the Bank's operations, regarding securities transactions, are in compliance with applicable law. Furthermore, the Compliance Officer is responsible for assessing and monitoring the Bank's compliance with Act on Measures against Money Laundering and Terrorist Financing no. 64/2006 and he is also the Bank's responsible officer under the US Foreign Account Tax Compliance Act (FATCA) and the OECD Common Reporting Standard (CRS). Moreover, the Compliance Officer oversees compliance risk within the Bank.

Íslandsbanki Values, Code of Conduct and Social Responsibility

Íslandsbanki's values are the pillars of the Bank's corporate culture, shaping the conduct and attitudes of its employees. The values insist on employees being professional, disciplined in their working procedures, and following matters through – professional, positive and progressive.

In order to maintain and strengthen the credibility and the reputation of the Bank, all employees were involved in formulating the Bank's Code of Conduct which is available on the Bank's website. The aim of the code is to promote good operational and business practices, increase trust and guide employees in their daily work.

Íslandsbanki seeks to work in harmony with the communities in which it operates, delivering support for its immediate environment in the areas of culture, sports, community affairs as well as entrepreneurship and innovation. This participation in community programmes rests on Íslandsbanki's Corporate Social Responsibility Strategy which is set by the Board. The strategy covers five key areas: business, education, environment, human capital, and society. Furthermore, the Bank produces an annual report, Íslandsbanki in the Community: Global Compact, which can be accessed on the Bank's website. For the last eight years Íslandsbanki has been a signatory to the UN Global Compact on social responsibility. The compact is a guide for companies on how to be socially responsible in practice.

Board of Directors

The Board of Directors comprises seven non-executive directors, and two alternates, elected at each AGM for a term of one year. The Chairman of the Board is elected by the shareholders' meeting. There are no limitations on duration of Board membership.

The Board undertakes the Bank's affairs in between shareholders' meetings unless otherwise provided by law or the Bank's Articles of Association. The Board is responsible for setting the Bank's general strategy and instructs the CEO on its further implementation and execution. The Board has a supervisory role in that it oversees that the Bank's organisation and activities are at all times in accordance with the relevant law, regulations and good business practices. The CEO and Chief Audit Executive are engaged by the Board.

Unaudited Appendix: Corporate Governance Statement 2016

The Rules of Procedure of the Board are adopted in accordance with Article 70 of the Act on Public Limited Companies no. 2/1995 and Article 54 of the Act on Financial Undertakings no. 161/2002. The Board's current rules of Procedure, adopted on 12 January 2017, are available on the Bank's website. According to its Rules of Procedure, at meetings of the Board the presence of at least five members of the Board is required to constitute a quorum. The Board met 19 times in 2016, each time constituting a quorum.

Candidates for board membership are nominated through a selection process administered by ISFI in accordance with Article 7 of the ISFI Act. The Articles of Association of the Bank provide that the ratio of each gender on the Board of Directors shall not be lower than 40%, currentlythe Board is comprised of four women and three men. In other respects than the foregoing the Board has not set a specific policy on Board diversity.

The Board appoints subcommittees, each one comprising Board members and operating under the terms of a mandate letter from the Board as well as the Rules of Procedure of the Board. The mandate letters of Board subcommittees are available on the Bank's website.

The Board Audit Committee, comprising three Board members, assists the Board in fulfilling its oversight responsibilities concerning the financial reporting process, the system of internal control, the audit process and the Bank's process for monitoring compliance with the relevant laws and regulations and its code of conduct. The committee met 10 times in 2016, each time constituting a quorum.

The Board Risk Management Committee, comprising four Board members, is responsible for assisting the Board in providing oversight of senior management's activities in managing risk relevant to the Bank's operations. This includes credit risk, market risk, operational risk, liquidity risk, compliance risk and reputational risk. The committee met 10 times in 2016, each time constituting a quorum.

The Board Corporate Governance, Compensation and Human Resource Committee, comprising three Board members, assists the Board in overseeing the development and the regular assessment of the Bank's approach to corporate governance issues and board effectiveness. Furthermore it is responsible for providing oversight regarding compensation and human resource issues. The committee met 7 times in 2016, each time constituting a quorum.

Structure and composition of Board subcommittees is as follows:

	The Board Corporate Governance, Compensation and HR Committee	The Board Audit Committee	The Board Risk Management Committee
Fridrik Sophusson	Chair		
Anna Thórdardóttir		Chair	Member
Audur Finnbogadóttir			Member
Árni Stefánsson			Member
Hallgrímur Snorrason	Member	Member	
Heidrún Jónsdóttir	Member	Member	
Helga Valfells			Chair

Member Chair

Members of the Board

Fridrik Sophusson, chairman of the Board, born in 1943, joined the Board in January 2010. He has comprehensive experience in fiscal policy-making, management, and public service in Iceland. He has also served as a board member in several companies and institutions. He was Managing Director of the Icelandic Management Association from 1972 until1978, when he was elected to Parliament. During his tenure as an MP, he held the position of Minister of Industry and Energy in 1987-1988 and Minister of Finance in 1991-1998. Fridrik was appointed CEO of Landsvirkjun, the National Power Company of Iceland, in 1999 and held that position for almost 11 years. He serves as chairman of the board of Hlídarendi ses. as well as as an alternate board member of Fondament ehf. Fridrik holds a Cand. Jur. degree in Law from the University of Iceland.

Sub-Committees: Chairman of the Board Corporate Governance, Compensation and Human Resource Committee.

Anna Thórdardóttir, born in 1960, joined the Board in April 2016. She has been a board member of a number of companies and other entities, including KPMG and the institute of State Authorised Public Accountants in Iceland. She is currently a member of the board of the Icelandic Center for Future Studies (Framtídarsetur Íslands) and the Chairman of the Board Audit Committee of Hagar hf. Anna was an employee of KPMG in 1988-2015 and a partner from 2009, and was responsible for the audit of the following companies: Reitir, Hagar, 365, Baugur Group, Vodafone, Landfestar, Landey, 10-11, and Félagsbústadir. Anna holds a Cand. Oecon. degree in Business Administration from the University of Iceland and she is a Chartered Accountant. She studied for Cand. Merc degree in Finance and Accounting at Handelhøjskolen in Århus, Denmark.

Sub-Committees: Chairman of the Board Audit Committee and a member of the Board Risk Management Committee.

Audur Finnbogadóttir, born in 1967, joined the Board in April 2016. She has extensive experience in the field of financial markets. She was Managing Director of Lífsverk pension fund, the pension fund for employees for the municipality of Kópavogur, and MP bank. She has held the position of Chairman of the Board of the Competition Authority in Iceland and been a member of the board of the Iceland Enterprise Investment Fund, Icelandair Group, Landsnet, Nordlenska and New Kaupthing Bank. Audur is currently a member of the board of Rotaryklúbbur Rvík-Austurbær. Audur holds a B.Sc. degree in International Business from the University of Colorado and an MBA from Reykjavík University. She is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs.

Sub-Committees: Member of the Board Risk Management Committee.

Árni Stefánsson, born in 1966, joined the Board in April 2016. He has extensive management experience in energy and heavy industries in Iceland. He is currently manager and member of the executive board at the primary aluminium plant Rio Tinto Alcan - ISAL. He was previously a manager and member of the executive board of Century Aluminium plant Nordurál in Grundartangi, a manager and vice-president theIcelandic electric transmission grid company Landsnet, and a manager with Landsvirkjun, the National Power Company of Iceland. Árni holds an M.Sc. degree and B.Sc. degree in electrical engineering from Alborg University in Denmark.

Sub-Committees: Member of the Board Risk Management Committee.

Hallgrímur Snorrason, born in 1947, joined the Board in April 2016. He is an independent consultant in official statistics. He was Director of Statistics Iceland in 1985-2007 and Deputy Managing Director of the National Economic Institute of Iceland in 1980-1984. Has been a member of the board of several companies, including Útvegsbanki Íslands, Skýrr and Audur Capital. He has also chaired a number of governmental committees, both domestically and in relation to cooperation with the Nordic region, EFTA, the EU and the OECD. Hallgrímur holds an M.Sc. degree in Economics from Lund University in Sweden and a B.Sc. degree in Economics from the University of Edinburgh.

Sub-Committees: Member of the Board Corporate Governance, Compensation and Human Resource Committee and the Board Audit Committee.

Heidrún Jónsdóttir, born in 1969, joined the Board in April 2016. She is an attorney at law with Fjeldsted and Blöndal Legal Services. Previously she served as the Managing Director of Legal and Human Resources at Eimskipafélag Íslands, Managing Director at Lex Legal Services, and Managing Director of Legal and Human Resources at KEA. She has extensive experience serving as a board member since 1998. She has been a Chairman of the Board of Directors at Nordlenska, Íslensk Verdbréf, and Gildi pension fund and has been a member of the board of Olíuverslun Íslands, Síminn, Reiknistofa bankanna, Ístak, the Icelandic Pension Funds Association, Silicor Materials Iceland, and Gildi pension fund. Heidrún holds a Cand. Jur degree from the University of Iceland and is a securities broker licensed by the Icelandic Ministry of Finance and Economic Affairs. In 2016-2017, she is attending AMP, the Advanced Management Program at IESE Business School in Barcelona.

Sub-Committees: Member of the Board Corporate Governance, Compensation and Human Resource Committee and the Board Audit Committee.

Helga Valfells, born in 1964, joined the Board in September 2013. Most recently she was the Managing Director of NSA Ventures, an Icelandic venture capital fund. Previous employers include Estée Lauder UK, Merrill Lynch Europe, and the Trade Council of Iceland. As an entrepreneur she has participated in founding start-up companies as well as acting as an advisor to the Icelandic Minister of Business Affairs. Furthermore, she has worked as an independent consultant for a number of export companies from Iceland, the UK, and Canada. She serves as Chairman of the Coard of Frumtak GP ehf. and is a member of the boards of Alþjódaskólinn á Íslandi ehf., Klak Innovit ehf., Mentor ehf., Transmit ehf., Dohop ehf. and Vesturgardur ehf. She is an alternate board member of Akthelia ehf., Azazo hf., FSÍ (Framtakssjódur Ísl) slhf., Greenqloud ehf., InfoMentor ehf. Íslensk Nýsköpun ehf. and Norrænar Myndir ehf. Helga holds a B.A. degree in Economics and English Literature from Harvard University and an MBA from London Business School.

Sub-Committees: Chairman of the Board Risk Management Committee.

Alternate members of the Board are two; **Herdís Gunnarsdóttir** and **Pálmi Kristinsson**, both since April 2016.

All members of the Board are considered independent from the Bank, its main clients, competitors and shareholder.

Board Performance Assessment

At least once a year, as provided for in the Board's Rules of Procedure, the Board assesses its work, procedures and practices as well as each of its members. This performance assessment is intended to improve working methods and increase the efficiency of the Board. The assessment entails an evaluation of the strengths and weaknesses of the Board's work and practices. This is i.a. based on Board members' self-assessment on whether the Board rules of procedure have been complied with in all respects, a status taken of the specific priorities set by the Board regarding risk management and internal control within the Bank as well as a follow up on how certain decisions of the Board have been implemented.

Executive Management

The Chief Executive Officer (CEO) is responsible for the day-to-day operations of the Bank pursuant to set policies and resolutions of the Board. The CEO is also required to ensure that the Bank's operations are in compliance with applicable law and the Bank's Articles of Association at all times. The CEO engages the Bank's Compliance Officer and appoints members of the Executive Board and other management committees.

Birna Einarsdóttir, born in 1961, is the CEO of Íslandsbanki. She holds a Cand. Oecon. degree in Business Administration from the University of Iceland and an MBA degree from the University of Edinburgh. Birna has been with Íslandsbanki and its predecessors in various divisions for 22 years and CEO since 15 October 15 2008. Previous to that she was a senior product manager at the Royal Bank of Scotland and Marketing Manager for the Icelandic Broadcasting Company Stöd 2 (Channel 2) and Íslensk Getspá. Birna is the Chairman of the Board of Icelandic Financial Services Association and is a member of the board of SA-Business Iceland. Birna is considered independent from the Bank, its main clients, competitors and shareholder.

Together with the CEO, the Executive Board manages the daily activities of the Bank according to the strategy set out by the Board. It consists of nine people, including the CEO: Birna Einarsdóttir, CEO since October 2008, Björgvin Ingi Ólafsson, Managing Director of Relationship Banking since October 2014, Elín Jónsdóttir, Managing Director of Wealth Management since July 2014, Jón Gudni Ómarsson, Chief Financial Officer since October 2011, Sigrídur Olgeirsdóttir, Chief Operating Officer since September 2010, Sverrir Örn Thorvaldsson, Chief Risk Officer since November 2010, Tryggvi Björn Davídsson, Managing Director of Markets since September 2011, Una Steinsdóttir, Managing Director of Retail Banking since October 2008 and Vilhelm Már Thorsteinsson Managing Director of Corporate Banking since October 2008.

The CEO and management committees are responsible for implementing risk management practices and internal monitoring in accordance with Board authorisation. The committees are appointed by the CEO, and their letters of mandate and rules of procedure approved by the Board.

The Executive Board is responsible for the Bank's operational risk management framework and supervises legal risk, reputational risk, business risk and strategic risk as well as the Bank's formal product approval policy.

The Risk Committee manages and supervises credit related matters and other counterparty risk, in accordance with the Bank's credit policy and lending rules.

The Asset and Liability Committee monitors other financial risks, such as market risk, liquidity risk, and interest rate risk in the Bank's non-trading portfolio.

The Investment Committee makes decisions on the purchase or sale of equity holdings in companies, as well as other types of investments, including investment funds and real estate.

Further to the above Human Resources, the Legal and Compliance departments report directly to the CEO.

Arrangement of communications between shareholders and the Board

The Board communicates with shareholders in accordance with the relevant laws, the Bank's Articles of Association and the Board's Rules of Procedure. Members of the Board of Directors shall, in their duties and decision-making, safeguard the interests of the Bank and its shareholders in accordance with the provisions of Act no. 2/1995, on Public Limited Companies, Act no. 161/2002, on Financial Undertakings, and other relevant rules and guidelines respecting the activities of financial undertakings.

At the end of 2016 the Bank was wholly owned by the Icelandic Government, directly and through its subsidiary ISB Holding ehf., which is also wholly owned by the Icelandic Government. The shares are administered by ISFI in accordance with the ISFI Act. Shareholders' meetings are the general forum for informing and communicating with shareholders. In between meetings of the Bank's shareholders the Chairman of the Board, on behalf of the Board of directors, is responsible for communications with shareholders.

Shareholders can at any time express their views in relation to the operations of the Bank to the Board of Directors and submit queries to the Board for discussion.

Information on infringements of laws and regulations that the appropriate supervisory or ruling body has determined.

On 27 October 2016 the FME and Íslandsbanki came to a settlement in respect of a violation of Article 18(1) of Act no. 108/2007 on securities transactions.

This Corporate Governance Statement was approved by Íslandsbanki's Board of Directors on 15 February 2017.