



KVÍKA

Consolidated Financial Statements

31 December 2017

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Endorsement and Statement by the Board of Directors and the CEO

The Consolidated Financial Statements of Kvika banki hf. ("Kvika" or the "Bank") for the year 2017 have been prepared in accordance with International Financial Reporting Standards (IFRSs) as adopted by the European Union, and additional requirements in the Icelandic Financial Statement Act. The Consolidated Financial Statements comprise Kvika and its subsidiaries (together the "Group").

Kvika banki hf. is a specialised investment bank focusing on asset management and capital markets. Kvika provides businesses, investors and individuals with comprehensive investment banking and asset management services as well as selected banking services. Kvika's asset management has an established reputation and offers solutions covering all major asset classes, including fixed-income securities, equities, and alternative investments in both domestic and international markets. At end of year 2017, the Group had ISK 263 billion of assets under management.

The Bank's Board of Directors propose that no dividend will be paid in the year 2018 on 2017 operations.

2017: Year of strong performance and external growth

In September 2017 Kvika Virðing hf. ("Virðing"), a licenced securities company focusing on asset- and fund management with ISK 100 billion of assets under management and 35 employees. At 17 November a merger between Kvika and Virðing was concluded. In October 2017 Kvika acquired Alda sjóðir hf., a fund management company with 44 billion of assets under management and 5 employees. Consequent to the acquisitions and at the end of December 2017 Kvika had ISK 263 billion of assets under management compared to ISK 121 billion at year end 2016. In September 2017, Kvika acquired Beringer Finance's Icelandic Corporate Finance practice comprising several mandates and four employees.

According to the Consolidated Statement of Financial Position, equity at the end of the year amounted to ISK 10,982 million (2016: ISK 7,397 million) and total assets amounted to ISK 75,597 million (2016: ISK 59,563 million).

According to the Consolidated Income Statement, the Group's net operating income during 2017 was ISK 5,009 million (2016: ISK 5,318 million). Net interest income increased significantly between the periods and amounted to ISK 1,563 million (2016: ISK 1,064 million), net fee income amounted to ISK 2,812 million (2016: ISK 2,840 million) and other operating income amounted to ISK 635 million (2016: ISK 1,414 million).

Administrative expenses amounted to ISK 3,670 million (2016: ISK 3,219 million). Since the acquisition of Virðing, substantial synergies have been achieved which will positively impact the Bank's profitability going forward. One off items relating to these synergies, such as costs relating to termination of employment agreements, significantly impact the results for 2017. The total amount of one off costs which are booked as administrative expenses is ISK 328 million, refer to note 8 for more information.

Profit for the year amounted to ISK 1,591 million (2016: ISK 1,955 million). Adjusted for one off costs the profit for the period is ISK 1,919 million corresponding to an annualised 24.9% return on equity based on the equity position at the beginning of the year adjusted for changes in share capital and transactions with treasury shares during the year.

The Group's total capital ratio at 31 December 2017 is 21.1% (31.12.2016: 20.6%). The Bank's minimum regulatory capital requirement based on Financial Supervisory Authority's Supervisory Review and Evaluation Process (SREP) is 14.5%. The minimum regulatory capital requirement including the additional capital requirements imposed following the implementation of CRD IV is 19.5% as at 31 December 2017 and 20.25% from 1 January 2018.

The Bank maintains a strong liquidity position. The Bank's assets are liquid and its access to funding is good, reflected by the Bank's funding cost decreasing significantly during the year. As at 31 December 2017 the Group's 30 day liquidity coverage ratio (LCR) was 215%, well above the minimum level of 100%.

Share capital and shareholders

The Bank's issued share capital amounted to ISK 1,815 million as at 31 December 2017 (2016: ISK 1,404 million). At the end of the year the Bank held treasury shares with a nominal value of ISK 10 million (2016: ISK 28 million). The Bank's share capital was increased by a nominal value of ISK 411 million during the second half of the year.

The Bank had 118 shareholders at year-end (2016: 36), of which 1 held more than 10% of shares in the Bank (2016: 0). The ownership of the Bank is transparent and it is the only bank that is fully owned by private entities, such as pension funds, companies and individuals. The ten largest shareholders are as follows:

Shareholder	31.12.2017	31.12.2016
Vátryggingafélag Íslands hf.	23.57%	-
RES II ehf.	9.32%	-
Lífeyrissjóður verzlunarmanna	8.96%	9.53%
K2B fjárfestingar ehf.	7.52%	8.00%
Mízar ehf.	6.20%	6.60%
Brimgarðar ehf.	4.74%	8.31%
Feier ehf.	3.14%	-
Sindrandi ehf.	2.52%	-
Lífsvirk lífeyrissjóður	2.19%	-
P 126 ehf.	2.17%	1.20%
	70.32%	33.65%

Further information about the shareholders of the Bank is provided in note 68.

Endorsement and Statement by the Board of Directors and the CEO

Risk management

The Bank is exposed to various types of risk in its operations. The Bank enforces a risk management framework which is further structured and outlined in the Bank's risk policy guide and rules on risk management. Refer to notes 43-57 on analysis of exposure to various types of risk.

Corporate governance

The Board of Directors emphasizes good corporate governance and adherence to accepted guidelines on corporate governance. The Board has laid down comprehensive rules in which the authority of the Board is defined and its scope of work in conjunction with the CEO. They address e.g. competence of Board members to participate in individual decisions, confidentiality and information disclosure between the CEO and the Board. Majority of Board members are independent of the Bank and there are no executive directors on the Board. The Bank aims to promote gender equality and three out of five board members are women.

The Board determines compensation for the CEO. The Board of Directors has delegated certain tasks to a subcommittee, the Risk, Audit and Remuneration Committee. The committee has three members appointed by the Board, the majority of which is independent of the Bank.

More information about the Bank's corporate governance, including a signed statement, can be found on the Bank's website, www.kvika.is.

Non-financial information

Following is a summary of the Bank's policy on social responsibility, environmental protection and human resources. The policy is accessible on the Bank's website, www.kvika.is

Social responsibility

According to Kvika's investment policy the interest of all stakeholders should always be considered in business transactions. Stakeholders include the bank's customers, employees, the bank's shareholders and the community. Kvika supports several organizations focusing community projects.

Environmental protection

Kvika strives to minimize negative environmental impact resulting from its operations. As an example, the Bank strives to minimise paper usage and offers commute benefits to employees which use environmentally friendly commuting.

Human resources

Kvika takes pride in providing employees with excellent working facilities and encouraging a healthy and positive working environment. The Bank also aims to provide equal opportunities and ensuring that everyone can reach their full potential regardless of ethnicity or gender.

Statement by the Board of Directors and the CEO

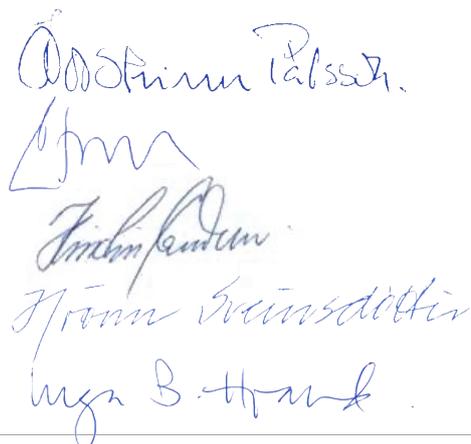
To the best of our knowledge the Consolidated Financial Statements of Kvika banki hf. for the year 2017 comply with International Financial Reporting Standards as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and give a true and fair view of the Group's assets, liabilities and financial position as at 31 December 2017 and the financial performance of the Group and changes of cash flows for the year 2017.

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

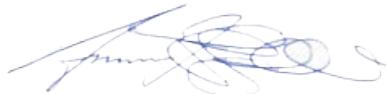
The Board of Directors and the CEO of the Bank have today discussed the Consolidated Financial Statements for the year 2017, and confirm them by the means of their signatures.

Reykjavík, 17 February 2018.

Board of Directors



CEO



Independent Auditors' Report

To the Board of Directors and Shareholders of Kvika banki hf.

Opinion

We have audited the consolidated financial statements of Kvika banki hf. for the year ended December 31, 2017 which comprise, the consolidated income statement and statement of comprehensive income, the consolidated statement of financial position, the consolidated statement of changes in equity, the consolidated statement of cash flows for the year then ended and the notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements give a true and fair view of the consolidated financial position of Kvika banki hf. as at December 31, 2017, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the consolidated Financial Statements section of our report. We are independent of Kvika banki hf. in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code) as well as the Icelandic Institute of State Authorized Public Accountants, Code of Ethics (FLE Code) and we have fulfilled our 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 Matters

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

Key Audit Matters	How the matter was addressed in our audit
<p>Loan valuation and impairment loss allowance</p> <p>We refer to note 80 and 92 related to accounting policies related to impairment loss allowance.</p> <p>Loans to customers are ISK 25,338 million and 33.3% of the balance sheet. As described in note 20 the group held impairment provisions of ISK 288.7 million against a gross loan book of ISK 25,627 million at 31 December 2017.</p> <p>The assessment of the group's calculation of impairment loss allowances for loans to customers requires management to make significant judgements including measurement of incurred but not specifically identified losses.</p> <p>Due to the significance of the judgement applied and the amount of loans of the group, auditing loan impairment charges is considered a key audit matter</p>	<p>We have tested the relevant controls over the impairment process, including controls the bank has in place for capturing loans that need to be reviewed for impairment.</p> <p>We selected a sample of loans from the full population, both performing and non-performing loans. For selected sample we have challenged the appropriateness of management's key processes and assumptions used in the calculations of impairment for loans and advances and assessed whether the provisions are in accordance with IFRS. This included the impaired accounts and valuation of underlying collateral.</p> <p>We assessed the technique management uses to estimate incurred but not reported losses, including benchmarking the assumptions against economic data and industry practices to validate assumptions made.</p> <p>We have reviewed the disclosures to the financial statements to confirm compliance with IFRS.</p>

Independent Auditors' Report

<p>Business combinations</p> <p>Two acquisitions have occurred in the year. As detailed in notes 3 and 110, ISK 2.24 billion of goodwill has been recognised in connection with the acquisitions.</p> <p>The accounting for these transactions is complex due to the management judgements taken in the application of accounting standards, for example the valuation of the businesses, the recognition and valuation of consideration, the identification and valuation of intangible assets and the accounting for the financial instruments.</p> <p>Due to this, we consider the business combination as a key audit matter.</p>	<p>We have performed the following procedures to address this key audit matter:</p> <ul style="list-style-type: none"> • Obtained and reviewed the share purchase agreements, due diligence reports and associated contractual agreements for the current year business combinations and understood the terms and conditions of each transaction to assess compliance with IFRS 3 Business Combinations; • Tested the initial consideration, either through cash or issuing of bills, to the signed purchase agreement and to bank statements and assessed the appropriateness of the fair value of the total consideration determined by management; • Assessed the valuation prepared by management to value the businesses and the intangible assets identified in the acquired businesses for both Virðing and Alda. Examined and assessed the inputs within the valuation, including the future growth patterns to the historical trends achieved in similar markets. <p>We also reviewed the disclosures presented in note 3 to the financial statements to confirm compliance with the provisions within IFRS 3.</p>
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Other information

The Board of Directors and CEO are responsible for the other information. The other information comprises the report of Board of Director.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon, except from our confirmation related to the report of Board of Director as described below.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information identified above 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, 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.

In accordance with Paragraph 2 article 104 of the Icelandic Financial Statement Act no. 3/2006, we confirm to the best of our knowledge that the accompanying report of the board of directors includes all information required by the Icelandic Financial Statement Act that is not disclosed elsewhere in the financial statements.

Responsibilities of the Board of Directors and the CEO for the Consolidated Financial Statements

The Board of Directors and CEO are responsible for the preparation and fair presentation of the consolidated financial statements in accordance with International Financial Reporting Standards (IFRSs) as adopted by the EU and additional requirements in the Icelandic Financial Statement Act, and for such internal control as the Board of Directors and CEO 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, the Board of Directors and CEO are responsible for assessing Kvika banki hf.'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 company or to cease operations, or has no realistic alternative but to do so.

The Board of Directors and Risk, Audit and Remuneration Committee are responsible for overseeing Kvika banki hf.'s consolidated financial reporting process.

Auditors' Responsibilities for the Audit of the Consolidated 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 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 ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

Independent Auditors' Report

- 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 Kvika banki hf.'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 Company'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 Kvika banki hf. 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 Kvika banki hf. to express an opinion on the consolidated and separate 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 the Board of Directors and Audit Committee 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 the Board of Directors and Audit Committee 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.

From the matters communicated with the Board of Directors and Audit Committee, we determine those matters that were of most significance in the audit of the consolidated 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.

Kópavogur, 17 February 2018.

Deloitte ehf.

Pálina Árnadóttir
State Authorized Public Accountant

Guðmundur Ingólfsson
State Authorized Public Accountant

Consolidated Income Statement

For the year 2017

	Notes	2017	2016
Interest income		4,657,949	4,189,589
Interest expense		(3,095,419)	(3,125,309)
Net interest income	4	1,562,530	1,064,281
Fee and commission income	5	3,033,265	2,880,710
Fee and commission expense		(221,118)	(40,521)
Net fee and commission income		2,812,146	2,840,188
Net financial income	6	547,234	1,282,690
Share in profit of discontinued operations		8,403	(13,488)
Share in profit of associates, net of income tax	23	63,912	148,985
Other operating income (expense)		15,005	(4,420)
Other operating income		634,554	1,413,767
Net operating income		5,009,230	5,318,236
Administrative expenses	8-11	(3,669,687)	(3,219,406)
Impairment of loans and receivables	20	(14,228)	(226,349)
Profit (loss) from assets held for sale		0	(3,395)
Revaluation on investment properties	24	92,258	0
Profit before taxes		1,417,573	1,869,086
Income tax	12	248,658	94,612
Special tax on financial activity	13	(23,047)	0
Special tax on financial institutions	14	(52,289)	(9,036)
Profit for the year		1,590,896	1,954,662
	Notes	2017	2016
Attributable to the shareholders of Kvika banki hf.		1,592,976	1,927,945
Attributable to non-controlling interest	22	(2,080)	26,717
Profit for the year		1,590,896	1,954,662

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Comprehensive Income

For the year 2017

	Notes	2017	2016
Profit for the year		1,590,896	1,954,662
Translation of foreign operations			
Exchange difference on translation of foreign operations		(4,668)	(3,367)
Other comprehensive income that are or may be reclassified to profit and loss, net of tax		(4,668)	(3,367)
Total comprehensive income for the year		1,586,228	1,951,295
	Notes	2017	2016
Attributable to the shareholders of Kvika banki hf.		1,588,309	1,924,578
Attributable to non-controlling interest		(2,080)	26,717
Total comprehensive income for the year		1,586,228	1,951,295

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Financial Position

As at 31 December 2017

Assets	Notes	31.12.2017	31.12.2016
Cash and cash equivalents	15	19,985,823	12,032,879
Receivables from Central Bank		507,916	0
Fixed income securities	16	5,598,409	3,945,778
Shares and other variable income securities	17	2,837,375	3,154,466
Securities used for hedging	18	14,026,433	12,389,392
Loans to customers	19, 20	25,338,250	26,015,321
Derivatives	21	1,052,652	552,493
Investment in associates	23	676,610	127,262
Investment properties	24	953,874	0
Intangible assets	26	2,284,340	41,530
Property and equipment	27	57,251	59,135
Deferred tax assets	28	464,414	189,429
Other assets	20, 29	1,797,913	967,954
Assets classified as held for sale	30	15,260	87,720
Total assets		75,596,519	59,563,359
Liabilities			
Deposits from customers	31	41,749,497	32,478,933
Borrowings	32	15,133,254	13,498,785
Issued bills	33	3,934,757	3,922,918
Subordinated liabilities	34	1,058,741	572,385
Short positions held for trading	35	370,163	80,186
Derivatives	21	364,692	498,769
Current tax liabilities	28	789	11,039
Deferred tax liabilities	28	65,658	1,789
Other liabilities	36	1,936,693	1,101,679
Total liabilities		64,614,243	52,166,483
Equity			
Share capital	37	1,805,060	1,375,819
Share premium		2,722,583	912,768
Option reserve		903	4,771
Warrants reserve	38	207,048	40,300
Deficit reduction reserve		3,103,697	3,103,697
Other reserves		(21,722)	(17,054)
Restricted retained earnings		254,844	403,553
Retained earnings		2,858,439	1,524,391
Total equity attributable to the shareholders of Kvika banki hf.		10,930,854	7,348,246
Non-controlling interest		51,423	48,630
Total equity		10,982,276	7,396,876
Total liabilities and equity		75,596,519	59,563,359

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Changes in Equity

For the year 2017

	Notes	Share capital	Share premium	Option reserve	Warrants reserve	Deficit reduction reserve	Translation reserve	Restricted retained earnings	Retained earnings	Total shareholders' equity	Non-controlling interest	Total equity
1 January 2017 to 31 December 2017												
Equity as at 1 January 2017		1,375,819	912,768	4,771	40,300	3,103,697	(17,054)	403,553	1,524,392	7,348,246	48,630	7,396,876
Profit for the year									1,592,976	1,592,976	(2,080)	1,590,896
Restricted retained earnings								(148,709)	148,709	0		0
Exchange difference on translation of foreign operations							(4,668)			(4,668)		(4,668)
Total comprehensive income for the year		0	0	0	0	0	(4,668)	(148,709)	1,741,685	1,588,309	(2,080)	1,586,228
Transactions with owners of the Bank												
Capital increase		300,000	1,368,000							1,668,000		1,668,000
Transactions with own shares		17,812	78,374							96,187		96,187
Dividend paid to shareholders									(407,638)	(407,638)		(407,638)
Stock options				(3,868)						(3,868)		(3,868)
Warrants sold					189,218					189,218		189,218
Warrants exercised		111,429	363,441		(22,470)					452,400		452,400
Other transactions												
Acquisition of non-controlling interest via purchase											188,422	188,422
Acquisition of non-controlling interest via merger											53,502	53,502
Sale of shares in subsidiaries											(237,052)	(237,052)
Equity as at 31 December 2017		1,805,060	2,722,583	903	207,048	3,103,697	(21,722)	254,844	2,858,439	10,930,854	51,423	10,982,276

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Changes in Equity

For the year 2016

	Notes	Share capital	Share premium	Option reserve	Warrants reserve	Deficit reduction reserve	Translation reserve	Restricted retained earnings	Retained earnings	Total shareholders' equity	Non-controlling interest	Total equity
1 January 2016 to 31 December 2016												
Equity as at 1 January 2016		1,590,644	850,445	3,228	11,070	3,850,917	(13,687)	0	0	6,292,617	238,537	6,531,154
Profit for the year									1,927,945	1,927,945	26,717	1,954,662
Restricted retained earnings								403,553	(403,553)			
Exchange difference on translation of foreign operations							(3,367)			(3,367)		(3,367)
Total comprehensive income for the year		0	0	0	0	0	(3,367)	403,553	1,524,392	1,924,578	26,717	1,951,295
Accumulated deficit set off against the share premium account			0									
Transactions with owners of the Bank												
Capital decrease		(252,779)				(747,221)				(1,000,000)		(1,000,000)
Impact of capital decrease on treasury shares		2,205	6,519							8,724		8,724
Impact of capital decrease on treasury shares due to purchased treasury shares			31,195							31,195		31,195
Treasury shares transactions	67	(42,172)	(142,828)							(185,000)		(185,000)
Transactions with own shares		26,110	105,746							131,857		131,857
Stock options				1,543						1,543		1,543
Warrants sold					40,300					40,300		40,300
Warrants exercised		51,812	61,690		(11,070)					102,432		102,432
Other transactions												
Acquisition of non-controlling interest via purchase											(28,581)	(28,581)
Decrease due to liquidation of subsidiaries											(211,641)	(211,641)
Sale of shares in subsidiaries											23,598	23,598
Equity as at 31 December 2016		1,375,819	912,768	4,771	40,300	3,103,697	(17,054)	403,553	1,524,392	7,348,246	48,630	7,396,876

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

Consolidated Statement of Cash Flows

For the year 2017

	Notes	2017	2016
Cash flows from operating activities			
Profit for the year		1,590,896	1,954,662
Adjustments for:			
Indexation and exchange rate difference		168,401	(790,119)
Share in loss (profit) of associates, net of income tax	23	(63,912)	(148,985)
Depreciation and amortisation	26, 27	78,183	31,142
Net interest income	4	(1,562,530)	(1,064,281)
Impairment of loans and receivables	20	14,228	226,349
Income tax	12	(225,611)	(94,612)
Investment properties, fair value change		(92,258)	0
Other adjustments		(156,955)	29,325
		(249,559)	143,482
Changes in:			
Receivables from Central Bank		(507,916)	0
Fixed income securities		(1,527,834)	646,816
Shares and other variable income securities		944,659	(366,135)
Securities used for hedging		(1,637,041)	(1,331,559)
Loans to customers		1,001,054	(4,556,609)
Derivatives - assets		(500,160)	(224,500)
Deferred tax assets and tax liabilities		(34,694)	15,022
Other assets		(886,249)	(219,922)
Deposits from customers		9,196,963	3,102,155
Deposits from credit institutions		0	(714,134)
Short positions		289,977	(1,727,866)
Derivatives - liabilities		(134,077)	(488,717)
Other liabilities		970,671	(220,879)
		7,175,352	(5,942,846)
Interest received		4,395,424	4,070,511
Interest paid		(2,956,732)	(2,641,197)
Income tax paid		0	(5,475)
Net cash from (to) operating activities		8,364,485	(4,519,006)
Cash flows from investing activities			
Acquisition of intangible assets	26	(48,680)	(6,519)
Acquisition of property and equipment	27	(5,099)	(10,367)
Proceeds from the sale of property and equipment		2,600	10,752
Proceeds from the sale of a non-controlling interest		0	49,868
Acquisition of subsidiary, net of cash		(2,839,819)	0
Acquisition of a associates		(797,879)	
Proceeds from the sale of associates		202,435	
Acquisition of a non-controlling interest		0	(28,581)
Proceeds from the sale of assets classified as held for sale		72,460	29,000
Acquisition of assets classified as held for sale		0	(37,656)
Net cash (to) from investing activities		(3,413,982)	6,498
Cash flows from financing activities			
Borrowings		702,392	(1,721,341)
Issued bills		11,839	(252,184)
Subordinated liabilities		427,615	(31,857)
Increase in warrants		166,748	0
Dividend paid to shareholders		(407,638)	0
Treasury share transactions		96,187	91,890
Increase (reduction) of share capital		2,142,870	(244,391)
Reduction of deficit reduction reserve		0	(747,221)
Net cash from (to) financing activities		3,140,013	(2,905,105)
Net increase (decrease) in cash and cash equivalents		8,090,516	(7,417,613)
Cash and cash equivalents at the beginning of the year	15	12,032,879	19,916,973
Change in cash and cash equivalents due to sale of subsidiary		57,931	0
Effects of exchange rate fluctuations on cash and cash equivalents held		(195,503)	(466,480)
Cash and cash equivalents at the end of the year	15	19,985,823	12,032,879
Investing and financing activities not affecting cash flows			
Acquisition of investment properties	24	861,616	0
Acquisition of borrowings		(861,616)	0

The notes on pages 13 to 61 are an integral part of these Consolidated Financial Statements.

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Notes to the Consolidated Financial Statements

General information

1. Reporting entity

Kvika banki hf. ("Kvika" or the "Bank") is a limited liability company incorporated and domiciled in Iceland, with its registered office at Borgartún 25, Reykjavík. The Bank operates as a bank based on Act No. 161/2002, on Financial Undertakings, and is supervised by the Financial Supervisory Authority of Iceland.

The Consolidated Financial Statements for the year ended 31 December 2017 comprise Kvika banki hf. and its subsidiaries (together referred to as the Group). Kvika is a specialised investment bank focusing on asset management and capital markets. Kvika and its subsidiaries provide businesses, investors and individuals with comprehensive investment banking and asset management services as well as selected banking services.

The Consolidated Financial Statements were approved and authorised for issue by the Board of Directors and the CEO on 17 February 2018.

2. Basis of preparation

a. Statement of compliance

The Consolidated Financial Statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union and additional requirements in the Icelandic Financial Statement Act. These Financial Statements are a translation of the Icelandic version of the Group's Consolidated Financial Statements for the year 2017.

b. Basis of measurement

The Consolidated Financial Statements have been prepared using the historical cost basis except for the following:

- Fixed income securities are measured at fair value
- Shares and other variable income securities are measured at fair value
- Securities used for hedging are measured at fair value
- Derivatives are measured at fair value
- Investment properties are measured at fair value
- Short positions are measured at fair value
- Assets classified as held for sale are measured at the lower of cost or fair value less cost to sell

A breakdown of the accounting classification of financial assets and financial liabilities is provided in note 58.

c. Functional and presentation currency

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

The Group's assets and liabilities which are denominated in other currency than ISK are translated to ISK using the exchange rate as at the end of day 31 December 2017.

d. Going concern

The Bank's management and Board of Directors has assessed the Group's ability to continue as a going concern and are satisfied that the Group has the resources to continue its operations.

e. Estimates and judgements

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

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

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

Information about areas of estimation uncertainty and critical judgements made by management in applying accounting policies that can have a significant effect on the amounts recognised in the Consolidated Financial Statements is provided in note 110.

f. Relevance and importance of notes to the reader

In order to enhance the informational value of the Financial Statements, the notes are evaluated based on relevance and importance for the reader.

g. Change in presentation of comparative figures

The comparative figures for the year 2016 in note 59 d.-h. have been amended as the current presentation is more accurate. This amendment has no effect on the results of the statement of comprehensive income or the statement of financial position.

Notes to the Consolidated Financial Statements

3. Acquisition of Virðing hf. and Alda sjóðir hf.

a. Acquisition of Virðing hf.

In September 2017, the Bank acquired Virðing hf. ("Virðing") and its subsidiaries, and is Virðing a part of the Group and Consolidated Financial Statements from 1 October 2017. Work began on merging the two companies immediately following the acquisition and was concluded on 17 November 2017. On that day the Bank took over all assets, liabilities and operations of Virðing in accordance with the decision of the board of directors in both companies, approvals of shareholder meetings and regulatory authorities. The activities and operations of Virðing have been integrated with those of the Bank and the merged company operates under the name Kvika banki hf. In 2017, the Bank incurred transaction costs and costs related to the merger, refer to note 8 for more information on operating expenses.

The consideration transferred, to the previous owners of Virðing, was in the form of a cash payment amounting to ISK 2,560 million. The purchase price was on the one hand financed with own funds and on the other hand through a share capital increase. A part of the purchase price, ISK 300 million, was deposited into an escrow account to be used to offset possible damages resulting from law suits that Virðing was party to. These funds will be paid to the former owners of Virðing pending the outcome of these law suits. Should the Bank, as a result of these law suits, have to pay damages then the first ISK 300 million will be paid using the funds in the escrow account, but any damages in excess of that amount will be at the expense of the Bank.

In accordance with IFRS 3, Business Combinations, the purchase price of Virðing was allocated to identifiable assets and liabilities acquired. The following table summarises the recognised amounts of assets and liabilities acquired by the Group at the date of the acquisition. Assets acquired from Virðing and its subsidiaries were recognised at the fair value amount of ISK 1,094 million. The liabilities assumed from Virðing and its subsidiaries were recognised at the fair value amount of ISK 383 million. The purchase price allocation of Virðing, as outlined below, is a preliminary assessment and will be finalised in the course of the financial year 2018.

Identifiable assets acquired and liabilities assumed

Assets	Fair value
Cash and cash equivalents	138,699
Fixed income securities	791
Shares and other variable income securities	459,635
Investment in associates	14,858
Property and equipment	8,358
Deferred tax assets	4,659
Other assets	467,492
Total	1,094,492
Liabilities	
Deferred tax liabilities	67,095
Other liabilities	315,961
Total	383,056
Non-controlling interest	53,503
Total identifiable net assets	657,934
Goodwill on acquisition	1,901,913
Acquisition price	2,559,847

Other assets are mostly comprised of receivables, such as asset management and fund management fees. It is management's opinion that there is no indication that these receivables will not be collected in full.

As the acquisition took place in September, the operating figures for the year are mostly comprised of figures related to Kvika banki hf. If the acquisition had occurred on 1 January 2017, it is estimated that the consolidated revenue would have been ISK 5,609 million and the consolidated profit for the year would have been ISK 1,484 million.

Notes to the Consolidated Financial Statements

3. Acquisition of Virðing hf. and Alda sjóðir hf. (cont.)

b. Acquisition of Alda sjóðir hf.

In October 2017, the Bank acquired Alda sjóðir hf. ("Alda") and its subsidiaries, and is Alda a part of the Group and Consolidated Financial Statements from 1 November 2017. The consideration transferred, to the previous owners of Alda, amounted to ISK 450 million. ISK 400 million were paid with own funds and ISK 50 million were paid with a vendor note. In 2017, the Bank incurred transaction costs and costs related to the merger, refer to note 8 for more information on operating expenses.

In accordance with IFRS 3, Business Combinations, the purchase price of Alda was allocated to identifiable assets and liabilities acquired. The following table summarises the recognised amounts of assets and liabilities acquired by the Group at the date of the acquisition. Assets acquired from Alda and its subsidiaries were recognised at the fair value amount of ISK 156 million. The liabilities assumed from Alda and its subsidiaries were recognised at the fair value amount of ISK 48 million. The purchase price allocation of Alda, as outlined below, is a preliminary assessment and will be finalised in the course of the financial year 2018.

Identifiable assets acquired and liabilities assumed

Assets	Fair value
Cash and cash equivalents	9,386
Fixed income securities	79,322
Shares and other variable income securities	40,740
Property and equipment	1,114
Deferred tax assets	8,007
Other assets	17,160
Total	155,728
Liabilities	
Other liabilities	48,335
Total	48,335
Total identifiable net assets	107,393
Goodwill on acquisition	342,607
Acquisition price	450,000

As the acquisition took place in October the operating figures for the year are mostly comprised of figures related to Kvika banki hf. If the acquisition had occurred on 1 January 2017, it is estimated that the consolidated revenue would have been ISK 5,189 million and the consolidated profit for the year would have been ISK 1,559 million.

Notes to the Consolidated Financial Statements

Income statement

4. Net interest income

Interest income is specified as follows:

	2017	2016
Cash and cash equivalents	1,282,411	1,357,964
Derivatives	1,094,009	877,645
Loans to customers	2,238,875	1,924,136
Other interest income	42,654	29,845
Total	4,657,949	4,189,589

Interest expense is specified as follows:

	2017	2016
Deposits from customers	1,349,277	1,369,387
Deposits from credit institutions	0	53,364
Borrowings	1,366,891	1,183,623
Issued bills	212,903	266,623
Subordinated liabilities	64,629	41,902
Derivatives	28,309	151,516
Other interest expense	73,411	58,894
Total	3,095,419	3,125,309

Total interest income recognised in respect of financial assets not carried at fair value through profit or loss amounts to ISK 3,569 million (2016: ISK 3,312 million). Total interest expense recognised in respect of financial liabilities not carried at fair value through profit or loss amounts to ISK 3,067 million (2016: ISK 2,974 million).

5. Fee and commission income

Fee and commission income is specified as follows:

	2017	2016
Banking	613,898	511,111
Capital Markets	712,626	856,194
Asset Management	1,167,792	1,138,437
Other	538,949	374,967
Total	3,033,265	2,880,710

6. Net financial income

Net financial income is specified as follows:

	2017	2016
Financial assets held for trading		
Fixed income securities	262,264	583,054
Shares and other variable income securities	113,660	268,231
Derivatives	107,638	150,839
Financial assets designated at fair value through profit or loss		
Fixed income securities	1,748	0
Shares and other variable income securities	43,247	166,767
Foreign currency exchange difference	18,679	113,798
Total	547,234	1,282,690

7. Foreign currency exchange difference

Foreign currency exchange difference is specified as follows:

	2017	2016
(Loss) gain on financial instruments at fair value through profit and loss	(59,950)	35,637
Gain on other financial instruments	78,628	78,162
Total	18,679	113,798

Note 55 provides information about the development of foreign exchange rates against the Icelandic krona.

Notes to the Consolidated Financial Statements

8. Administrative expenses

Administrative expenses are specified as follows:

	2017	2016
Salaries and related expenses	2,396,227	2,073,879
Other operating expenses	1,099,111	1,047,275
Depositors' and Investors' Guarantee Fund contributions	96,166	67,111
Depreciation and amortisation	78,183	31,142
Total	3,669,687	3,219,406

In the year 2017, ISK 328 million in one-off and irregular operating expenses were incurred by the Bank due to acquisitions, mergers and organizational changes. Of that amount, ISK 236 million are included among salaries and related expenses and ISK 92 million are included among other operating expenses in the table above.

9. Salaries and related expenses

Salaries and related expenses are specified as follows:

	2017	2016
Salaries	1,863,502	1,626,341
Performance based payments excluding share-based payments	10,350	(10,846)
Share-based payment expenses	14,496	1,543
Pension fund contributions	249,321	218,612
Tax on financial activity	114,804	100,833
Other salary related expenses	143,754	137,395
Total	2,396,227	2,073,879
Average number of full time employees during the year	91	84
Total number of full time employees at year-end	107	86

The figures for 2016 do not include employees of Virðing hf. ("Virðing") and its subsidiaries, employees of Alda sjóðir hf. ("Alda") or employees of Beringer Finance's Icelandic Corporate Finance division ("Beringer Finance"). At the beginning of 2017, Virðing had 35 full time employees, Alda had 5 full time employees, Beringer Finance had 4 full time employees and Kvika and its subsidiaries had 86, or 130 in total.

According to Act No. 165/2011, passed in 2011, banks and other financial institutions providing VAT exempt services, must pay a tax based on salary payments, called tax on financial activity. The current tax rate is 5.50% (2016: 5.50%).

10. Employment terms of the Board of Directors and management

Salaries and benefits paid to the Board of Directors, the CEO and Managing Directors of the Bank for their work for companies within the Group, and their shareholding in the Bank, are specified as follows:

	31.12.2017			31.12.2016		
	Salaries and benefits	Number of shares	Warrants and options	Salaries and benefits	Number of shares	Warrants and options
Árman Þorvaldsson, CEO	21,186	2,082	22,008	0	0	0
Sigurður Atli Jónsson, former CEO	80,743	0	9,979	48,212	8,425	24,566
Þorsteinn Pálsson, Chairman of the Board	9,892	0	0	9,174	0	0
Guðmundur Þórðarson, Deputy Chairman of the Board	3,974	136,463	0	0	0	0
Inga Björg Hjaltadóttir, Board member	5,024	0	0	4,741	0	0
Hrönn Sveinsdóttir, Board member	4,047	0	0	0	0	0
Kristín Guðmundsdóttir, Board member	4,932	634	0	4,331	621	0
Pétur Guðmundarson, alternate Board member	2,512	0	0	0	0	0
Jónas Hagan Guðmundsson, former Board member	7,535	0	0	6,850	26,993	0
Finnur Reyr Stefánsson, former Board member	976	0	0	4,587	51,033	0
Anna Skúladóttir, former Board member	976	0	0	3,515	8,425	0
Skúli Mogensen, former Board member	0	0	0	1,053	101,989	0
Þórunn Pálsdóttir, former Board member	0	0	0	1,073	0	0
Árman Fr. Ármannsson, former alternate Board member	479	0	0	1,639	93	0
Managing Directors (2017: 6, 2016: 5)	140,062	2,757	149,483	184,375	1,264	100,050
Former managing Directors (2017: 2, 2016: 0)	74,516	0	38,529	0	0	0
Total	356,855	141,936	219,998	269,550	198,842	124,616

Salaries and benefits are substantially all short-term employee benefits.

Notes to the Consolidated Financial Statements

10. Employment terms of the Board of Directors and management (cont.)

Figures for shares, share options and warrants are in thousands and include shares held by companies owned by or under the control of the respective parties as at 31 December 2017 and 31 December 2016. If the holdings are held indirectly through companies, then the pro rata ownership of the aforementioned persons has been included.

The Bank has defined three Managing Directors as Key Employees, as defined in Act No. 161/2002 on Financial Undertakings. Furthermore the Bank has approved and published internal rules covering the qualification requirements, evaluation process and conduct of Key Employees, in accordance with requirements set forth by the Icelandic Financial Supervisory Authority.

The Bank has adopted a remuneration policy at the proposal of the Remuneration Committee. The policy covers three remuneration components, base pay, performance based incentive scheme and other benefits, including pension fund contributions. Further information about the remuneration policy is provided in notes 65-67.

11. Auditor's fees

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

	2017	2016
Audit of annual accounts	27,108	33,635
Review of interim accounts	6,194	6,768
Other audit related services	6,142	4,705
Total	39,444	45,107
Thereof to the auditors of the Bank	33,166	35,454

12. Income tax

The Group will not pay income tax on its profit for 2018 due to the fact that it has a tax loss carry forward that offsets the calculated income tax. At year end 2017, the tax loss carry forward of the Group amounted to ISK 159 billion. A substantial part of the tax loss carry forward is utilisable until end of year 2018 and 2019. Management is of the opinion that the Group's operations in the years to come will result in taxable results which will be offset with the tax loss carry forward. The Group has therefore recognised a part of the tax loss carry forward as a deferred tax asset in the consolidated statement of financial position. The deferred tax asset is recognised only to the extent that it is probable to be utilisable against future taxable profits. The deferred tax asset is reviewed at each reporting date.

Income tax is recognised based on the tax rates and tax laws enacted during the current year, according to which the domestic corporate income tax rate was 20.0% (2016: 20.0%)

Reconciliation of effective tax rate:

	2017		2016	
Profit before tax		1,417,573		1,869,086
Income tax using the domestic corporation tax rate	20.0%	(283,515)	20.0%	(373,817)
Non-deductible expenses	0.3%	(4,218)	0.0%	(351)
Non-taxable income	4.0%	(56,221)	(8.1%)	151,748
Recognition of tax losses	(36.8%)	522,072	(16.1%)	301,472
Other changes	(5.0%)	70,540	(0.8%)	15,561
Effective income tax	(17.5%)	248,658	(5.1%)	94,612

Profit before tax amounts to ISK 1.418 billion. Income tax amounts to ISK 249 million, resulting in an effective tax rate of -17.5%. This is substantially different from the Icelandic corporate tax rate of 20%, mainly due to non-taxable income from shares and revaluation of the deferred tax asset.

13. Special tax on financial activity

The special tax on financial activity is an additional income tax which becomes effective when the income tax base exceeds ISK 1,000 million. It is levied on the same entities as the tax on financial activity according to Act No. 90/2003. The tax rate is set at 6% (2016: 6%) and the tax is not a deductible expense for income tax purposes. The tax is presented separately in the consolidated income statement.

14. Special tax on financial institutions

According to Act No. 155/2010 on Special Tax on Financial Institutions, certain types of financial institutions, including banks, must pay annually a tax based on the carrying amount of their liabilities as determined for tax purposes in excess of ISK 50 billion at year-end. The tax rate is set at 0.376% (2016: 0.376%) and the tax is not a deductible expense for income tax purposes. The tax is presented separately in the consolidated income statement.

Notes to the Consolidated Financial Statements

Statement of Financial Position

15. Cash and cash equivalents

Cash and cash equivalents are specified as follows:

	31.12.2017	31.12.2016
Deposits with the Central Bank of Iceland	9,128,425	8,363,848
Cash on hand	24,813	15,375
Balances with banks	7,043,106	3,263,947
Foreign treasury bills	3,789,480	389,709
Total	19,985,823	12,032,879

16. Fixed income securities

Fixed income securities are specified as follows:

	31.12.2017	31.12.2016
Held for trading		
Listed government bonds and bonds with government guarantees	1,767,992	1,521,804
Listed treasury bills	499,267	0
Listed bonds	3,110,155	2,268,305
Unlisted bonds	220,994	155,669
Total	5,598,409	3,945,778

17. Shares and other variable income securities

Shares and other variable income securities are specified as follows:

	31.12.2017	31.12.2016
Held for trading		
Listed shares	1,266,507	1,144,496
Unlisted shares	687,328	136,997
Unlisted unit shares	879,916	1,437,759
Designated at fair value through profit or loss		
Unlisted shares	3,623	430,779
Unlisted unit shares	0	4,434
Total	2,837,375	3,154,466

Further discussion about the accounting classification of financial assets is provided in note 58-60.

18. Securities used for hedging

Securities used for hedging are specified as follows:

	31.12.2017	31.12.2016
Listed government bonds and bonds with government guarantees	3,519,268	5,298,637
Listed bonds	1,740,609	21,243
Listed shares	8,681,677	6,990,913
Unlisted unit shares	84,880	78,599
Total	14,026,433	12,389,392

Securities used for hedging are classified as held for trading. Further discussion about the accounting classification of financial assets is provided in notes 58-60.

19. Loans to customers

Loans to customers are specified as follows:

	31.12.2017	31.12.2016
Loans to customers, gross amount	25,626,960	26,321,932
Specific allowance for impairment losses	(28,436)	(44,404)
Collective allowance for impairment losses	(260,274)	(262,208)
Total	25,338,250	26,015,321

Notes to the Consolidated Financial Statements

20. Allowance for impairment losses

Change in allowance for impairment losses is specified as follows:

a. Loans to customers

31.12.2017	Specific	Collective	Total
Balance as at 1 January 2017	44,404	262,208	306,611
Charge to the income statement for the year	20,677	(1,934)	18,744
Recoveries	(20,815)	0	(20,815)
Write-offs	(15,829)	0	(15,829)
Balance as at 31 December 2017	28,436	260,274	288,710

31.12.2016	Specific	Collective	Total
Balance as at 1 January 2016	208,880	205,869	414,748
Charge to the income statement for the year	207,497	56,339	263,836
Recoveries	(35,829)	0	(35,829)
Write-offs	(336,144)	0	(336,144)
Balance as at 31 December 2016	44,404	262,208	306,611

b. Other assets - accounts receivable

31.12.2017	Specific	Collective	Total
Balance as at 1 January 2017	73	5,000	5,073
Charge to the income statement for the year	16,300	0	16,300
Write-offs	0	0	0
Balance as at 31 December 2017	16,373	5,000	21,373

31.12.2016	Specific	Collective	Total
Balance as at 1 January 2016	10,132	5,000	15,132
Charge to the income statement for the year	(1,658)	0	(1,658)
Write-offs	(8,401)	0	(8,401)
Balance as at 31 December 2016	73	5,000	5,073

21. Derivatives

Derivatives are specified as follows:

31.12.2017	Notional		Carrying value	
	Assets	Liabilities	Assets	Liabilities
Interest rate derivatives	3,596,957	3,503,988	92,969	0
Currency forwards	1,027,214	1,022,872	8,126	3,784
Bond and equity total return swaps	15,009,156	14,429,317	889,858	310,019
Equity options	245,967	0	61,699	50,889
Bond options	0	0	0	0
	19,879,293	18,956,176	1,052,652	364,692

31.12.2016	Notional		Carrying value	
	Assets	Liabilities	Assets	Liabilities
Interest rate derivatives	1,020,000	1,020,000	71,224	0
Currency forwards	2,997,361	2,863,685	146,318	12,641
Bond and equity total return swaps	1,075,779	13,709,091	249,496	478,462
Equity options	2,867	0	75,294	0
Bond options	600,000	600,000	10,161	7,665
	5,696,008	18,192,775	552,493	498,769

Notes to the Consolidated Financial Statements

22. Group entities

The main subsidiaries held directly or indirectly by the Group are listed in the table below.

Entity	Nature of operations	Domicile	Share	Share
			31.12.2017	31.12.2016
Alda sjóðir hf.	Fund management	Iceland	100%	-
Fí Fasteignafélag GP ehf.	Real estate fund management	Iceland	100%	100%
Júpíter rekstrarfélag hf.	Fund management	Iceland	100%	100%
M-Investments ehf.	Holding company	Iceland	100%	100%
Netgíró reikningar ehf.	Holding company	Iceland	100%	-
Netgíró lán ehf.	Holding company	Iceland	100%	-
Rafklettur ehf.	Holding company	Iceland	100%	-
Rekstrarfélag Virðingar hf.	Fund management	Iceland	100%	-
AC GP 3 ehf.	Fund management	Iceland	80%	-
Kvika Securitates Ltd.	Business consultancy services	UK	100%	-

Akta sjóðir hf., was a subsidiary at the beginning of 2017 but is an associate company at end of the period as the Group sold ca. 2% of its shareholding during the period.

23. Investment in associates

a. Investment in associates is accounted for using the equity method and is specified as follows:

Entity	Nature of operations	Domicile	Share	Share
			31.12.2017	31.12.2016
Akta sjóðir hf.	Fund management	Iceland	49%	51%
Kjölfesta GP ehf.	Holding company	Iceland	50%	0%
Kortþjónustan hf.	Payment Institution	Iceland	42%	0%
Londonderry Associates LLC	Holding company	USA	-	38%
Nes Þróunarfélag slhf.	Holding company	Iceland	-	33%

The Group does not consider its associates material, neither individually nor as a group.

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

	31.12.2017	31.12.2016
Balance at the beginning of the year	127,262	0
Additions through a merger	8,558	0
Acquisition of shares in associates	611,216	0
Disposal of shares in associates	(182,519)	(23,152)
Reclassification	48,181	1,429
Share in profit of associates, net of income tax	63,912	148,985
Total	676,610	127,262

24. Investment properties

Investment properties are specified as follows:

	31.12.2017	31.12.2016
Balance as at 1 January 2017	0	0
Acquisitions	861,616	0
Revaluation on investment properties	92,258	0
Total	953,874	0

In October 2017, the Group acquired investment properties through one of its subsidiaries, Rafklettur ehf. The intention is to either earn rental income or capital appreciation or both. The book value of investment properties is based on the most recent appraisal values by licensed real estate agents, current listing prices and/or recent transactions for comparable real estates or valuation models based on gross income multipliers. In 2017, the Group received rental income amounting to ISK 16 million and incurred direct operating expenses of ISK 2 million.

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25. Unconsolidated structured entities

Where the Group acts as an agent for the investor, it does not consolidate the investment funds. When the Group holds investments in unconsolidated investment funds, they are classified as financial investments designated at fair value through profit or loss or other financial investments held for trading. The fair value of these investments represents the Group's maximum exposure to loss from its investments in such unconsolidated investment funds.

The nature and purpose of Investment funds is to generate fees from managing assets on behalf of third party investors. These vehicles are financed through the issuance of units to investors.

	31.12.2017	31.12.2016
Investments funds	133,984,761	49,837,884

The following table shows an analysis of the carrying amounts of interests held by the Group in unconsolidated structured entities. The Group's maximum exposure to loss is the carrying amount of the assets held.

	Carrying amount	
	31.12.2017	31.12.2016
Investments funds	522,667	987,600

The Group received management fees during the period:	2017	2016
Investments funds	531,350	481,664

26. Intangible assets

Intangible assets are specified as follows:

31.12.2017	Goodwill	Software	Other	Total
Balance as at 1 January 2017	0	20,790	20,740	41,530
Acquisitions	0	8,680	40,000	48,680
Additions through a business combination	2,244,521	0	0	2,244,521
Amortisation	0	(5,511)	(44,880)	(50,391)
Balance as at 31 December 2017	2,244,521	23,959	15,860	2,284,340
Gross carrying amount	2,244,521	38,924	48,800	2,332,245
Accumulated amortization and impairment losses	0	(14,965)	(32,940)	(47,905)
Balance as at 31 December 2017	2,244,521	23,959	15,860	2,284,340
31.12.2016	Goodwill	Software	Other	Total
Balance as at 1 January 2016	0	20,304	25,620	45,924
Acquisitions	0	6,519	0	6,519
Additions through a business combination	0	0	0	0
Amortisation	0	(6,033)	(4,880)	(10,913)
Balance as at 31 December 2016	0	20,790	20,740	41,530
Gross carrying amount	0	38,924	48,800	87,724
Accumulated amortization and impairment losses	0	(18,620)	(23,180)	(41,800)
Balance as at 1 January 2016	0	20,304	25,620	45,924
Gross carrying amount	0	38,924	48,800	87,724
Accumulated amortization and impairment losses	0	(18,134)	(28,060)	(46,194)
Balance as at 31 December 2016	0	20,790	20,740	41,530

Goodwill was required due to the acquisitions of Virðing hf. and Alda sjóðir hf. as further detailed in note 3. The acquisitions are recent and based on the valuations and management estimates, the Board of Directors considers that there is no indication of impairment.

Notes to the Consolidated Financial Statements

27. Property and equipment

Property and equipment is specified as follows:

	Furniture and fixtures	Computer equipment	Other	Total
31.12.2017				
Balance as at 1 January 2017	14,569	10,425	34,141	59,135
Acquisitions	0	1,408	3,691	5,099
Additions through a business combination	4,490	4,605	377	9,472
Discontinued	0	0	0	0
Disposals	0	(2,184)	0	(2,184)
Depreciation	(3,444)	(4,646)	(6,180)	(14,270)
Reclassified	0	0	0	0
Balance as at 31 December 2017	15,615	9,608	32,028	57,251
Gross carrying amount	42,802	40,225	197,507	280,533
Accumulated depreciation	(27,187)	(30,617)	(165,478)	(223,282)
Balance as at 31 December 2017	15,615	9,608	32,028	57,251
31.12.2016				
Balance as at 1 January 2016	20,105	25,698	30,946	76,749
Acquisitions	0	0	10,367	10,367
Additions through a business combination	0	0	0	0
Discontinued	0	0	(4,162)	(4,162)
Disposals	0	0	(4,121)	(4,121)
Depreciation	(4,030)	(10,124)	(5,544)	(19,697)
Reclassified	(1,506)	(5,150)	6,656	0
Balance as at 31 December 2016	14,569	10,425	34,141	59,135
Gross carrying amount	42,802	41,001	56,361	140,163
Accumulated depreciation	(22,697)	(15,302)	(25,415)	(63,414)
Balance as at 1 January 2016	20,105	25,698	30,946	76,749
Gross carrying amount	38,895	39,458	41,933	120,287
Accumulated depreciation	(24,326)	(29,033)	(7,792)	(61,152)
Balance as at 31 December 2016	14,569	10,425	34,141	59,135

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28. Deferred tax assets and liabilities

Change in deferred tax is specified as follows:

	31.12.2017	31.12.2016
Balance at the beginning of the year	187,640	102,575
Income tax for the year	248,658	94,612
Additions through a merger	(53,096)	0
Current income tax payable	789	11,039
Other changes	14,765	(20,587)
Net	398,756	187,640
Deferred tax assets	464,414	189,429
Deferred tax liabilities	(65,658)	(1,789)
Net	398,756	187,640

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

	31.12.2017	31.12.2016
Property and equipment	(1,970)	1,903
Intangible assets	6,800	(3,860)
Assets and liabilities denominated in foreign currencies	(9,340)	(5,380)
Other items	(61,386)	(73,218)
Tax losses carried forward	464,653	268,195
Total	398,756	187,640

At year end 2017, tax losses carried forward amount to ISK 159 billion, and are set to expire as follows:

	Tax losses
Tax losses 2008, expiring in 2018	55,524,917
Tax losses 2009, expiring in 2019	96,929,489
Tax losses 2010, expiring in 2020	66,358
Tax losses 2011, expiring in 2021	764,208
Tax losses 2012, expiring in 2022	640,623
Tax losses 2013, expiring in 2023	1,511,014
Tax losses 2014, expiring in 2024	781,928
Tax losses 2015, expiring in 2025	3,041,144
Tax losses 2016, expiring in 2026	0
Total	159,259,682

29. Other assets

Other assets are specified as follows:

	31.12.2017	31.12.2016
Unsettled transactions	290,598	108,739
Accounts receivable	1,147,904	716,360
Sundry assets	359,411	142,855
Total	1,797,913	967,954

30. Assets classified as held for sale

The Group has classified certain assets as held for sale. They are not part of the the Group's core operations. The Group intends to dispose of the majority of these assets in 2018 by offering them for sale either to select investors or through an open sales process.

Assets classified as held for sale are specified as follows:

	31.12.2017	31.12.2016
Buildings and land	15,260	60,220
Unlisted shares	0	27,500
Total	15,260	87,720

31. Deposits from customers

Deposits from customers are specified as follows:

	31.12.2017	31.12.2016
Demand deposits	33,097,311	23,311,754
Time deposits	8,652,186	9,167,179
Total	41,749,497	32,478,933

Notes to the Consolidated Financial Statements

32. Borrowings

Borrowings are specified as follows:

	31.12.2017	31.12.2016
Issued bonds	1,401,879	0
Loans from credit institutions	609,897	0
Money market deposits	13,076,921	13,498,785
Other borrowings	44,557	0
Total	15,133,254	13,498,785

Money market deposits typically have a principal of ISK 5-500 million and maturity between 1 day and 6 months and pay fixed interest rates.

The Bank has not had any defaults of principal, interest or other breaches with respect to its debt issued and other borrowed funds.

33. Issued bills

Issued bills are specified as follows:

	31.12.2017	31.12.2016
Issued bills	3,934,757	3,922,918
Total	3,934,757	3,922,918

34. Subordinated liabilities

a. Subordinated liabilities:

	Issued	Maturity	Maturity	Terms of interest	31.12.2017	31.12.2016
	2015	2025	type	CPI-Indexed, fixed 5.50%		
Tier 2 in ISK			At maturity		1,058,741	572,385
Total					1,058,741	572,385

At the interest payment date in the year 2020 the annual interest rate increases from 5.50% p.a. to 7.50% p.a. At the same date, the Group has the right to repay the subordinated bond and on any subsequent interest payment dates until maturity.

Subordinated liabilities are financial liabilities in the form of subordinated capital which, in case of the Group's voluntary or compulsory winding-up, will not be repaid until after the claims of ordinary creditors have been met. In the calculation of the capital ratio, they are included within Tier 2. The Group may only retire subordinated liabilities with the permission of the Icelandic Financial Supervisory Authority.

In the calculation of the capital ratio, subordinated liabilities are categorised as Tier 2 and are included in the equity base. The amount eligible for Tier 2 capital treatment is amortized on a straight-line basis over the final 5 years to maturity or up to 20% a year.

b. Subordinated liabilities are specified as follows:

	31.12.2017	31.12.2016
Balance at the beginning of the year	572,385	562,339
Additional issuance	450,000	0
Paid interest	(55,000)	(29,998)
Paid interests due to indexation	(1,755)	(489)
Accrued interests	63,594	30,250
Accrued interests due to indexation	29,517	10,282
Total	1,058,741	572,385

35. Short positions held for trading

Short positions held for trading are specified as follows:

	31.12.2017	31.12.2016
Listed government bonds and bonds with government guarantees	305,041	0
Listed bonds	65,122	80,186
Total	370,163	80,186

Short positions held for trading are classified as held for trading. Further discussion about the accounting classification of financial liabilities is provided in notes 58-60.

Notes to the Consolidated Financial Statements

36. Other liabilities

Other liabilities are specified as follows:

	31.12.2017	31.12.2016
Unsettled transactions	556,716	204,520
Accounts payable and accrued expenses	219,834	98,330
Special taxes on financial institutions and financial activities	75,336	8,948
Withholding taxes	472,874	380,040
Salaries and salary related expenses	403,924	188,588
Other liabilities	208,009	221,253
Total	1,936,693	1,101,679

37. Equity

a. Share capital

The share capital issued by the Bank is divided into two classes; class A and class B. The total share capital of the Bank is ISK 1,815,060,274; more specifically the share capital in class A amounts to ISK 1,805,060,274 and in class B it amounts to 10,000,000. The nominal value of shares issued by the Bank is ISK 1 per share in both share capital classes. Class A shares carry voting rights of one vote per nominal value of ISK 1 at shareholders' meetings, class B shares do not carry voting rights. Reference is made to the Bank's Articles of Association for more information about rights and restrictions associated with both classes of share capital.

	31.12.2017	31.12.2016
Share capital according to the Bank's Articles of Association	1,815,061	1,403,632
Nominal amount of treasury shares	10,000	27,812
Authorised but not issued shares	878,571	190,000

b. Changes made to the nominal amount of share capital

The Bank's Class A share capital was increased twice during the year 2017, in total for a nominal value of ISK 411 million. In September 2017 the share capital was increased by ISK 300,000,000 in nominal value in relation to the Bank's acquisition of Virðing hf. and in December 2017 the share capital was increased by ISK 111,428,574 in nominal value as holders of outstanding warrants exercised their rights to purchase new shares in the Bank.

c. Share capital increase authorizations

According to the Bank's Articles of Association dated 27 December 2017, the Board of Directors is authorized to increase the class A share capital of the Bank by up to ISK 100 million through subscription for new shares. This authorization is based on temporary provision I to the Articles of Association and is valid until 15 March 2022.

Temporary provision IV to the Articles of Association authorizes the Board of Directors to issue warrants and increase the share capital accordingly. According to section A of temporary provision IV the Board of Directors is authorised to increase class A share capital by up to ISK 550 million to serve issued warrants. According to section B of temporary provision IV the Board of Directors is furthermore granted a conditioned authorisation to increase class A share capital by an additional amount of ISK 200 million to serve issued warrants. The authorisation under section B of temporary provision IV is directly linked to the Board of Directors' authorisation under section A of temporary provision I.

The aforementioned authorisation under section B of temporary provision IV currently stands at ISK 150 million. However, should the Board of Directors utilise its authorisation according to section A of temporary provision I and increase the Bank's share capital by ISK 100 million, the authorisation under section B of temporary provision IV will increase from ISK 150 million to ISK 200 million, as stipulated in the provision. The Board of Directors' authorisation under temporary provision IV to increase share capital thus currently totals ISK 700 million but can increase to ISK 750 million by the usage by the Board of Directors of its authorisation pursuant to section A of temporary provision I. This authorisation is for class A share capital and is valid until 14 July 2022.

The Board of Directors is furthermore authorized to increase the class A share capital of the Bank in stages by up to ISK 50,000,000 in nominal value, for the purposes of fulfilling share option agreements in accordance with the Bank's share incentive scheme. The Board of Directors is also authorized to increase the class B share capital of the Bank by up to ISK 10,000,000 shares, by issuance of new class B shares. Both of these authorizations are based on temporary provision I, cf. paragraphs B and C of the provision, to the Articles of Association and are valid until 30 November 2021.

Temporary provision III to the Articles of Association moreover authorizes the Board of Directors to issue new class A share capital to serve warrants which have been issued in the maximum amount of ISK 18,571,426 nominal value, each of which contains the right to subscribe for one new class A share in the Bank.

A copy of the Bank's Articles of Association, including the temporary provisions, is available on the Bank's website, www.kvika.is, reference is made to them for more detailed information on issued warrants.

Notes to the Consolidated Financial Statements

38. Warrants

In October 2016 the Bank issued warrants for class A share capital for ISK 130,000,000 in nominal value, the warrants are valid for 36 months from date of issue. The subscription rate for each new share on exercise of the warrants shall be equal to 3.84 per share with a 5% annual increase. In December 2017 a part of the warrants were exercised for a nominal value of ISK 111,482,574 and the Bank's class A share capital was increased by the same nominal amount. The terms of the warrants stipulate that the nominal value which a warrant holder can subscribe to shall be adjusted accordingly, as can be seen in the section which discusses the terms of the warrants in temporary provision III to the Bank's Articles of Association dated 27 December 2017. Taking into consideration the adjustment clause, the holders of the remaining warrants issued in October 2016, are authorised to subscribe for class A share capital of ISK 88,422,172 in nominal value.

In September and December 2017 the Bank issued warrants for class A share capital for ISK 626,000,000 in nominal value. The warrants are valid for five years from date of issue. The holders of the warrants can exercise them as follows: (1) to a third (1/3) of the subscription shares in the period from when two years have elapsed from the issue of the warrants until three years have elapsed from the issue of the warrants, (2) to a third (1/3) of the subscription shares in the period from when three years have elapsed from the issue of the warrants until five years have elapsed from the issue of the warrants, and (3) to a third (1/3) of the subscription shares in the period from when four years have elapsed from the issue of the warrants until five years have elapsed from the issue of the warrants. The subscription rate for each new share on exercise of the warrants shall be 5.56 with a 7.5% annual increase for 604,000,000 in nominal value issued in September and 6.30 with a 7.5% annual increase for 22,000,000 in nominal value issued in December. A more detailed coverage on the warrants and their terms can be found in the Bank's Articles of Association, reference is made to them for more information.

39. Capital adequacy ratio (CAD)

Equity at the end of the year was ISK 10.982 million (31.12.2016: 7.397 million), equivalent to 14,5% of total assets according to the statement of financial position (31.12.2016: 12,4%). The capital adequacy ratio of the Group, calculated in accordance with Article 84 of Act No. 161/2002 on Financial Undertakings, was 21,1% (31.12.2016: 20,6%). The minimum according to the Act is 8,0%. The ratio is calculated as follows:

	31.12.2017	31.12.2016
Capital base		
Total equity	10,982,276	7,396,876
Goodwill and intangibles	(2,284,340)	(41,530)
Deferred tax asset	(464,414)	(189,429)
Tier 1 capital	8,233,523	7,165,917
Subordinated liabilities	1,058,741	572,385
Accrued interests	(19,097)	(10,503)
Tier 2 capital	1,039,643	561,881
Shares in financial institutions	(216,862)	(90,798)
Subordinated fixed income securities	(201,855)	(155,786)
Total capital base	8,854,450	7,481,214
Capital requirements	31.12.2017	31.12.2016
Credit risk	2,140,527	1,912,501
Market risk	480,415	336,155
Operational risk	738,179	654,211
Total Capital requirements	3,359,121	2,902,868
Surplus capital	5,495,329	4,578,346
Capital adequacy ratio (CAD)	21.1%	20.6%
Minimum capital requirements	14.5%	11.8%

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

Minimum capital requirement is based on the Bank's Internal Capital Adequacy Assessment Process (ICAAP) and is reviewed by the FME through the Supervisory Review and Evaluation Process (SREP). The Bank's minimum regulatory capital requirement, based on the SREP from 2017, is 14.5%. The minimum regulatory capital requirement including the additional capital requirements imposed following the implementation of CRD IV is 19.5% as at 31 December 2017 and 20.25% from 1 January 2018.

Notes to the Consolidated Financial Statements

Risk management

40. Risk management framework

a. Board of Directors

The Bank's Board of Directors has overall responsibility for the establishment and oversight of the Group's risk management framework and risk appetite setting. Risk management policies are reviewed regularly to reflect changes in market conditions and the Group's activities. The Group, through training and management standards and procedures, aims to develop a disciplined and constructive control environment in which all employees understand their roles and obligations.

b. Board of Directors sub-committee

The Bank's Board of Directors has established a sub-committee, Risk, Audit and Remuneration committee. The Committee has a number of roles, such as overseeing how management monitors compliance with the Group's risk management policies and procedures, monitoring the preparation of financial statements, reviewing the auditors' independence and composing the remuneration policy and monitoring the Bank's compliance to it. The Risk, Audit and Remuneration Committee is assisted in its oversight role by the Internal Audit.

c. CEO

The CEO is responsible for the effective implementation through the corporate governance structure and committees. The CEO has established three committees, which are responsible for developing and monitoring risk management policies in their specified areas.

d. Committees

The Bank operates three committees that are involved in risk management: an Asset and Liability Committee (ALCO), a Credit Committee and a Quality and Security Committee.

The ALCO Committee meets regularly and each department reports on its operations and positions activity since the previous meeting. The committee addresses matters regarding the Bank's risk management, financing, capital management and proprietary trading.

The Credit Committee addresses matters regarding the Bank's loan activities. The committee is responsible for the approval of individual loans as well as deciding on credit limits for individual clients in derivative trades, and is the primary forum for the discussion of loan activity policy.

The Quality and Security Committee is responsible for supervision and implementation of the Bank's security and quality policies. The security policy mainly addresses data security and operational security in IT systems, physical security for the personnel and proper access controls and monitoring in the Bank's premises. The quality work is aimed at upholding proper quality in work processes, IT systems and services to support performance and profitability, lower operational risk and increase the customer experience.

e. Risk management

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

f. Compliance Officer

The Compliance unit ensures that the Group adheres to its rules on securities trading and insider trading and operation comply with the Act on Securities Transactions, the Act on Actions to Combat Money Laundering and Terrorist Financing and other relevant legislation and regulations.

g. Internal Audit

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

41. Hedging

A part of the Group's portfolio consists of securities held as a hedge against derivatives positions of customers. The Group hedges currency exposure between the Group's loan portfolio and debts to the extent possible, but does not apply hedge accounting.

Notes to the Consolidated Financial Statements

42. Credit risk - overview

a. Definition

One of the Group's primary sources of risk is counterparty credit risk. Credit risk is defined as the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

b. Management

The risk management unit is responsible for managing and reporting on credit risk. The Group uses a variety of tools and processes to manage credit risk, including collaterals, hedges and loan portfolio management.

c. Credit approval process

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

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

d. Collateral

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

The Group places emphasis on pricing loans according to the value and quality of pledged collateral. The Group applies appropriate haircuts on all collateral in order to ensure proper risk mitigation. For all collateral in listed securities, the Group maintains the right to liquidate collateral in case its market value falls below a predefined limit.

To a very large extent the Group's loan portfolio consists of senior loans, most of which are highly collateralised.

e. Credit rating, control and provisioning

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

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

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

f. Loan portfolio management

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

g. Impairment

The Group's impairment policy is discussed in notes 79-80.

h. Renegotiation of terms and forbearance

The Group's forbearance policy is discussed in note 80.

i. Derivatives

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

j. Securities used for hedging

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

Notes to the Consolidated Financial Statements

Risk management

43. Maximum exposure to credit risk

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

	Public entities	Financial institutions	Corporate customers	Individuals	31.12.2017
Cash and cash equivalents	12,942,717	7,043,106			19,985,823
Receivables from Central Bank	507,916				507,916
Fixed income securities	3,332,061	2,247,209	19,139		5,598,409
Securities used for hedging	4,051,933	1,207,944			5,259,877
Loans to customers		60,005	21,728,318	3,549,927	25,338,250
Derivatives		349,086	664,121	39,445	1,052,652
Other assets	33,732	41,520	1,626,143	96,517	1,797,913
	20,868,359	10,948,869	24,037,721	3,685,890	59,540,839
Loan commitments		298,838	2,128,138	382,601	2,809,577
Financial guarantee contracts			434,237		434,237
Total	20,868,359	11,247,706	26,600,097	4,068,492	62,784,654

	Public entities	Financial institutions	Corporate customers	Individuals	31.12.2016
Cash and cash equivalents	8,768,932	3,263,947			12,032,879
Receivables from Central Bank					0
Fixed income securities	2,005,306	1,940,472			3,945,778
Securities used for hedging	5,298,637	21,243			5,319,880
Loans to customers		192	23,870,342	2,144,787	26,015,321
Derivatives		197,160	340,307	15,026	552,493
Other assets	4,646	81,402	820,361	61,546	967,954
	16,077,522	5,504,417	25,031,009	2,221,358	48,834,305
Loan commitments	100	249,794	3,114,935	571,296	3,936,125
Financial guarantee contracts			448,970	1,410	450,380
Total	16,077,622	5,754,211	28,594,913	2,794,064	53,220,810

44. Credit quality of financial assets

a. Breakdown

Credit quality of financial assets is specified as follows:

	Neither past due nor individually impaired	Past due but not individually impaired	Individually impaired	Total	Less specific impairment allowance	Less collective impairment allowance	Carrying amount
31.12.2017							
Cash and cash equivalents	19,985,823			19,985,823			19,985,823
Receivables from Central Bank	507,916			507,916			507,916
Fixed income securities	5,598,409			5,598,409			5,598,409
Securities used for hedging	5,259,877			5,259,877			5,259,877
Loans to customers	23,767,646	1,813,169	46,146	25,626,960	(28,436)	(260,274)	25,338,250
Derivatives	1,052,652			1,052,652			1,052,652
Other assets	1,802,986		16,300	1,819,286	(16,373)	(5,000)	1,797,913
Total	57,975,309	1,813,169	62,445	59,850,923	(44,809)	(265,274)	59,540,839

Notes to the Consolidated Financial Statements

44. Credit quality of financial assets (cont.)

	Neither past due nor individually impaired	Past due but not individually impaired	Individually impaired	Total	Less specific impairment allowance	Less collective impairment allowance	Carrying amount
31.12.2016							
Cash and cash equivalents	12,032,879			12,032,879			12,032,879
Receivables from Central Bank				0			0
Fixed income securities	3,945,778			3,945,778			3,945,778
Securities used for hedging	5,319,880			5,319,880			5,319,880
Loans to customers	25,034,535	1,233,180	54,217	26,321,932	(44,404)	(262,208)	26,015,321
Derivatives	552,493			552,493			552,493
Other assets	960,050		12,978	973,028	(73)	(5,000)	967,954
Total	47,845,615	1,233,180	67,195	49,145,990	(44,477)	(267,208)	48,834,305

b. Past due but not individually impaired

Past due but not individually impaired financial assets are those assets where contractual payments are 1 or more days past due but the Group believes that impairment is not appropriate on the basis of the level of security or future cash flows of the borrower. Past due loans are reported as the total claim value and not only those payments that are past due.

	31.12.2017	31.12.2016
Past due 1-30 days	1,522,288	779,818
Past due 31-60 days	96,162	76,763
Past due 61-90 days	990	34,066
Past due 91-180 days	188,984	254,053
Past due 180-360 days	4,745	86,645
Past due more than 360 days	0	1,835
Total	1,813,169	1,233,180

c. Individually impaired

Individually impaired financial assets are those assets where there is objective evidence of impairment, the asset has been individually assessed and comparison of the carrying amount and the present value of the expected cash flow from the asset reveals a need for impairment. All individually impaired assets are considered non-performing.

	Impaired but not Past due	Past due 1-30 days	Past due 31-60 days	Past due 60-90 days	Past due over 90 days	Claim value
31.12.2017						
Corporate						
Services					16,109	16,109
Retail					18,895	18,895
Individuals			432		27,010	27,442
Total	0	0	432	0	62,013	62,445

	Impaired but not Past due	Past due 1-30 days	Past due 31-60 days	Past due 60-90 days	Past due over 90 days	Claim value
31.12.2016						
Corporate						
Services					33	33
Retail		11,795			409	12,204
Individuals	332		741		53,886	54,959
Total	332	11,795	741	0	54,328	67,195

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45. Breakdown of loans to customers

a. By industry

The breakdown of the loan portfolio by industries is specified as follows:

	Claim value	Impairment allowance	Carrying amount	%
31.12.2017				
Financial institutions	60,655	(650)	60,005	0.2%
Corporate				
Services	8,596,517	(101,670)	8,494,847	33.5%
Holding companies	7,244,461	(77,675)	7,166,786	28.3%
Real estate, construction and industry	3,319,089	(35,587)	3,283,502	13.0%
Retail	1,202,059	(22,133)	1,179,925	4.7%
Other	1,620,635	(17,376)	1,603,258	6.3%
Individual	3,583,545	(33,617)	3,549,927	14.0%
Total	25,626,960	(288,710)	25,338,250	100.0%

	Claim value	Impairment allowance	Carrying amount	%
31.12.2016				
Financial institutions	194	(2)	192	0.0%
Corporate				
Services	9,854,258	(98,138)	9,756,120	37.5%
Holding companies	8,007,463	(79,674)	7,927,789	30.5%
Real estate, construction and industry	2,934,062	(29,220)	2,904,842	11.2%
Retail	2,050,827	(26,533)	2,024,294	7.8%
Other	1,269,944	(12,647)	1,257,297	4.8%
Individual	2,205,183	(60,397)	2,144,787	8.2%
Total	26,321,932	(306,611)	26,015,321	100.0%

b. By seniority

The following definitions are used when ranking the loan portfolio by seniority:

- Senior I
Loans in this category have first priority claims on the borrower's assets, are secured with collateral which can be marked to market and have asset coverage exceeding 100%.
- Senior II
Loans in this category have sufficient coverage and liquid collateral, but the collateral can in some cases not be marked to market, e.g. unlisted shares.
- Junior
Junior loans have second lien claims on the borrower's assets or lower levels of collateral coverage.
- Mezzanine
Mezzanine loans are loans which are unsecured and subordinated to all of the borrower's other liabilities.

The breakdown of loans by categories is as follows:

	Senior I	Senior II	Junior	Mezzanine	31.12.2017
Neither past due nor individually impaired	5,879,042	9,995,383	4,093,497	3,554,139	23,522,061
Past due but not individually impaired	387,816	535,733	323,319	551,611	1,798,480
Individually impaired		9,447		8,262	17,709
Total	6,266,858	10,540,564	4,416,817	4,114,011	25,338,250

	Senior I	Senior II	Junior	Mezzanine	31.12.2016
Neither past due nor individually impaired	7,508,171	9,453,015	5,272,486	2,595,227	24,828,899
Past due but not individually impaired	103,068	850,635	34,232	188,674	1,176,609
Individually impaired			5,092	4,722	9,813
Total	7,611,239	10,303,650	5,311,810	2,788,623	26,015,321

Notes to the Consolidated Financial Statements

46. Collateral and other credit enhancements

a. Valuation

The Group applies the same valuation methods to collateral held as other comparable assets held by the Group. The methods used for financial assets are outlined in note 59. For other types of assets the Group uses third party valuation where possible. Haircuts are then applied to account for liquidity and other factors which may affect the collateral value of the asset or other credit enhancement.

b. Loans to customers

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2017
Financial institutions	25,499	52,629	176,586				254,714
Corporate customers	605,792	81,471	8,026,087	10,357,144	29,483	453,024	19,553,001
Individuals	19,562	23,918	1,010,639	808,731			1,862,850
Total	650,853	158,018	9,213,312	11,165,875	29,483	453,024	21,670,565

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2016
Financial institutions	1,613		4,593	139,100			145,307
Corporate customers	1,131,224	158,720	8,876,706	9,187,516	79,110	2,291,118	21,724,394
Individuals	596,001	3,717	900,443	1,690,500		72,861	3,263,522
Total	1,728,838	162,437	9,781,742	11,017,116	79,110	2,363,979	25,133,223

Amounts have been adjusted to exclude collateral in excess of claim value, i.e. overcollateralization. Other collateral includes financial claims, inventories, receivables and letters of credit and guarantees.

c. Derivatives

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2017
Financial institutions	182,198	188,761	1,283,782				1,654,741
Corporate customers	672,466	48,134	771,690				1,492,290
Individuals	31		63,024				63,054
Total	854,695	236,894	2,118,496	0	0	0	3,210,085

	Deposits	Fixed income securities	Variable income securities	Real estate	Other fixed assets	Other	31.12.2016
Financial institutions	121,270	62,716	1,104,215				1,288,201
Corporate customers	425,072	27,040	161,865				613,977
Individuals	12,461	23,435	7,362				43,258
Total	558,804	113,190	1,273,442	0	0	0	1,945,436

Amounts have been adjusted to exclude collateral in excess of claim value, i.e. overcollateralization.

Notes to the Consolidated Financial Statements

47. Loan-to-value

a. General

The loan-to-value ratio (LTV) is the ratio of the gross amount of the loan to the value of the collateral, if any. The general creditworthiness of a customer is viewed as the most reliable indicator of credit quality of a loan. Valuation of collateral held against loans is therefore not updated unless the creditworthiness of a borrower deteriorates.

b. Breakdown

The breakdown of loans to customers by LTV is specified as follows:

	31.12.2017	%	31.12.2016	%
Less than 50%	11,880,633	46.9%	10,532,850	40.5%
51-70%	4,149,003	16.4%	8,883,928	34.1%
71-90%	3,013,046	11.9%	2,921,438	11.2%
91-100%	509,725	2.0%	580,677	2.2%
More than 100%	3,890,730	15.4%	1,912,570	7.4%
No collateral	1,895,112	7.5%	1,183,858	4.6%
Total	25,338,250	100.0%	26,015,321	100.0%

48. Large exposures

In accordance with the Financial Supervisory Authority's regulation no. 625/2013 on financial institutions' large exposures, total exposure towards a customer is classified as a large exposure if it exceeds 10% of the Bank's capital base (see note 39).

According to the regulation a single exposure, net of risk adjusted mitigation, cannot exceed 25% of the capital base. Single large exposures net of risk adjusted mitigation take into account the effects of collateral held by the Bank, and other credit enhancements, in accordance with the Financial Supervisory Authority's regulation no. 625/2013.

	31.12.2017		31.12.2016	
Large exposures before risk adjusted mitigation	Number	Amount	Number	Amount
10-20% of capital base	9	9,531,399	9	8,371,512
20-25% of capital base	0	0	0	0
Exceeding 25% of capital base	2	7,126,328	0	0
Total	11	16,657,727	9	8,371,512
Thereof nostro accounts with foreign banks with S&P rating of A- or higher	2	4,521,688	1	1,066,824
Large exposures net of risk adjusted mitigation	2	2,275,732	4	3,539,017

No single large exposure net of risk adjusted mitigation exceeds 25% of capital base in accordance with the Financial Supervisory Authority's regulation no. 625/2013.

49. Liquidity risk

a. Definition

Liquidity risk is the risk that the Group will encounter difficulty in meeting contractual payment obligations associated with its financial liabilities that are settled by delivering cash or another financial asset. This risk mainly arises from mismatches in the timing of cash flows. The Group has internal rules that require certain matching of the maturities of assets and liabilities. Furthermore, to ensure the ability to meet liquidity needs, the Group maintains a stock of highly liquid unencumbered assets, e.g. cash, treasury bills and treasury bonds.

b. Management

Liquidity is managed by treasury and monitored by risk management. Liquidity position is reported to the ALCO committee. The Central Bank of Iceland sets minimum requirements for the coverage ratio between cash flows of assets and liabilities (LCR) and stable funding in foreign currencies (NSFR). The minimum 30 day LCR was 100% in 2017 (100% for non-ISK assets). The minimum NSFR in foreign currencies was 100% in 2017 and is unchanged for 2018.

The Group was in compliance with internal and external liquidity requirements throughout the years 2017 and 2016. At year-end 2017 the liquidity coverage ratio (LCR) was 215%.

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49. Liquidity risk

Maturity analysis of financial assets and financial liabilities

31.12.2017	Up to 1	1-3	3-12	1-5	Over 5	Gross	Carrying
Financial assets by type	month	months	months	years	years	inflow/ (outflow)	amount
<i>Non-derivative assets</i>							
Cash and cash equivalents	19,985,823					19,985,823	19,985,823
Receivables from Central Bank	507,916					507,916	507,916
Fixed income securities	5,406,714	201,855				80,858	5,689,427
Shares and other variable income securities	2,131,471		1,208,706			3,340,177	2,837,375
Securities used for hedging	14,024,316					14,024,316	14,026,433
Loans to customers	4,063,760	2,748,727	12,829,736	6,069,743	648,233	26,360,200	25,338,250
Other assets	640,310	609,507	227,096	321,000		1,797,913	1,797,913
	46,760,310	3,560,089	14,265,538	6,390,743	729,092	71,705,772	70,092,119
<i>Derivative assets</i>							
Inflow	9,947,067		375,150	96,957		10,419,174	
Outflow	(9,052,929)		(375,990)	(3,988)		(9,432,907)	
	894,138	0	(840)	92,969	0	986,267	1,052,652
<i>Financial liabilities by type</i>							
<i>Non-derivative liabilities</i>							
Deposits from customers	(33,377,234)	(4,140,390)	(3,049,209)	(1,253,664)	(84,226)	(41,904,723)	41,749,497
Borrowings	(656,108)	(3,691,450)	(9,557,440)	(748,806)	(75,926)	(14,729,730)	15,133,254
Issued bills		(2,000,000)	(2,000,000)			(4,000,000)	3,934,757
Subordinated liabilities			(57,457)	(171,101)	(1,267,459)	(1,496,017)	1,058,741
Short positions held for trading	(370,163)					(370,163)	370,163
Other liabilities	(636,290)	(756,258)	(493,383)	(50,761)		(1,936,693)	1,936,693
	(35,039,794)	(10,588,098)	(15,157,490)	(2,224,332)	(1,427,611)	(64,437,326)	64,183,104
<i>Derivative liabilities</i>							
Inflow	4,595,729	315,474				4,911,204	
Outflow	(4,874,413)	(350,460)				(5,224,873)	
	(278,684)	(34,986)	0	0	0	(313,670)	364,692
Unrecognized financial items							
<i>Loan commitments</i>							
Inflow	695,435	445,258	1,168,098	563,953		2,872,743	
Outflow	(2,809,577)					(2,809,577)	
<i>Financial guarantee contracts</i>							
Inflow	434,237					434,237	
Outflow	(434,237)					(434,237)	
	(2,114,143)	445,258	1,168,098	563,953	0	63,165	
Summary							
Non-derivative assets	46,760,310	3,560,089	14,265,538	6,390,743	729,092	71,705,772	
Derivative assets	894,138		(840)	92,969		986,267	
Non-derivative liabilities	(35,039,794)	(10,588,098)	(15,157,490)	(2,224,332)	(1,427,611)	(64,437,326)	
Derivative liabilities	(278,684)	(34,986)				(313,670)	
Net assets (liabilities) excluding unrecognized items	12,335,970	(7,062,995)	(892,792)	4,259,380	(698,519)	7,941,044	
Net unrecognized items	(2,114,143)	445,258	1,168,098	563,953		63,165	
Net assets (liabilities)	10,221,827	(6,617,737)	275,306	4,823,333	(698,519)	8,004,209	

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49. Liquidity risk (cont.)

31.12.2016	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Gross inflow/ (outflow)	Carrying amount
Financial assets by type							
<i>Non-derivative assets</i>							
Cash and cash equivalents	12,032,879					12,032,879	12,032,879
Receivables from Central Bank						0	
Fixed income securities	3,796,989	155,786				3,952,775	3,945,778
Shares and other variable income securities	2,347,676	108,784	398,787			2,855,248	3,154,466
Securities used for hedging	12,386,983					12,386,983	12,389,392
Loans to customers	2,651,812	2,317,530	14,134,985	7,351,537	2,093,201	28,549,065	26,015,321
Other assets	310,050	406,096	232,780	19,028		967,954	967,954
	33,526,389	2,988,195	14,766,553	7,370,565	2,093,201	60,744,904	58,505,791
<i>Derivative assets</i>							
Inflow	3,313,749	1,400,801	61,736	14,656		4,790,942	
Outflow	(3,004,761)	(1,310,430)	(4,874)	(295)		(4,320,359)	
	308,989	90,371	56,862	14,361	0	470,583	552,493
Financial liabilities by type							
<i>Non-derivative liabilities</i>							
Deposits from customers	(28,279,499)	(4,971,818)	(128,723)	(24,616)		(33,404,656)	32,478,933
Borrowings	(863,954)	(7,730,163)	(4,881,445)			(13,475,562)	13,498,785
Issued bills		(2,000,000)	(2,000,000)			(4,000,000)	3,922,918
Subordinated liabilities	(30,409)		(30,892)	(123,566)	(685,232)	(870,099)	572,385
Short positions held for trading	(80,366)					(80,366)	80,186
Short positions used for hedging	(2,733)					(2,733)	
Other liabilities	(243,696)	(655,445)	(182,653)	(19,885)		(1,101,679)	1,101,679
	(29,500,657)	(15,357,426)	(7,223,713)	(168,067)	(685,232)	(52,935,095)	51,654,885
<i>Derivative liabilities</i>							
Inflow	11,102,030	107,974	76,717			11,286,721	
Outflow	(11,630,563)	(114,400)	(80,457)			(11,825,420)	
	(528,533)	(6,426)	(3,740)	0	0	(538,699)	498,769
Unrecognized financial items by type							
<i>Loan commitments</i>							
Inflow	159,202	411,530	2,357,881	1,168,847		4,097,461	
Outflow	(3,936,125)					(3,936,125)	
<i>Financial guarantee contracts</i>							
Inflow	450,380					450,380	
Outflow	(450,380)					(450,380)	
	(3,776,922)	411,530	2,357,881	1,168,847	0	161,336	
Summary							
Non-derivative assets	33,526,389	2,988,195	14,766,553	7,370,565	2,093,201	60,744,904	
Derivative assets	308,989	90,371	56,862	14,361		470,583	
Non-derivative liabilities	(29,500,657)	(15,357,426)	(7,223,713)	(168,067)	(685,232)	(52,935,095)	
Derivative liabilities	(528,533)	(6,426)	(3,740)			(538,699)	
Net assets (liabilities) excluding unrecognized items							
.....	3,806,189	(12,285,286)	7,595,963	7,216,859	1,407,970	7,741,694	
Net unrecognized items	(3,776,922)	411,530	2,357,881	1,168,847		161,336	
Net assets (liabilities)	29,266	(11,873,756)	9,953,844	8,385,706	1,407,970	7,903,030	

Maturity analysis of financial assets and financial liabilities is based on contractual cash flows or, in the case of held for trading securities, expected cash flows. If an amount receivable or payable is not fixed, e.g. for inflation indexed assets and liabilities, the maturity analysis uses estimates based on current conditions.

Cash flows relating to unrecognized balance sheet items (unused loan commitments and financial guarantee contracts) are presented separately from financial assets and financial liabilities. Both contractual outflows and inflows are shown, to fully reflect the nature of these items.

It should be noted that the Group's expected cash flows sometimes vary considerably from the contractual cash flows, most significantly in that demand deposits from customers are expected to remain stable or increase in the long term. In this case the presentation used reflects the worst case scenario from the Group's perspective. Furthermore, the analysis does not consider any measures that could be taken to convert long-term assets to cash through sale.

Notes to the Consolidated Financial Statements

50. Market risk

a. Definition

Market risk constitutes risk due to changes in the market prices of financial instruments and comprises interest rate risk, currency risk and other price risk. Notes 51-56 relate to market risk exposure.

b. Management

The Group has a strict policy on controlling market risk and to keep the exposure within set limits. The risk management unit monitors market risk limits on a daily basis and reports regularly to the ALCO committee and to the CEO.

51. Interest rate risk

a. Definition

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

Proprietary positions which are subject to interest rate risk fall under the scope of the Group's market risk management.

b. Management

The Group takes measures to minimise interest rate risk by matching the interest rate profile and duration of assets with the Group's liabilities as well as using derivative and non-derivative financial instruments to manage effectively the risk of an adverse impact on the Group's earnings.

52. Interest rate risk associated with trading portfolios

a. Breakdown

The breakdown of financial assets and liabilities in trading portfolios by the earlier of interest repricing time or maturity is specified as follows:

	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	31.12.2017
Fixed income securities	499,064			2,066,324	3,033,020	5,598,409
Short positions - fixed income securities					(370,163)	(370,163)
Net imbalance	499,064	0	0	2,066,324	2,662,857	5,228,246
	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	31.12.2016
Fixed income securities			60,943	2,355,274	1,581,206	3,997,424
Short positions - fixed income securities				(80,366)		(80,366)
Net imbalance	0	0	60,943	2,274,908	1,581,206	3,917,058

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in trading portfolios that are subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

	Shift in basis points	31.12.2017 Downward	31.12.2017 Upward	31.12.2016 Downward	31.12.2016 Upward
Indexed	50	50,527	(50,527)	43,866	(43,866)
Non-indexed	100	144,730	(144,730)	29,431	(29,431)
Total		195,257	(195,257)	73,297	(73,297)

53. Interest rate risk associated with non-trading portfolios

a. Breakdown

The breakdown of financial assets and liabilities in non-trading portfolios by the earlier of interest repricing time or maturity is specified as follows:

31.12.2017

Financial assets	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Cash and cash equivalents	16,196,343	3,789,480				19,985,823
Loans to customers	22,759,578	1,780,949	531,258	211,702	54,762	25,338,250
Financial assets excluding derivatives	38,955,922	5,570,429	531,258	211,702	54,762	45,324,073
Effect of derivatives	13,675,973	350,460		3,500,000		17,526,433
Total	52,631,895	5,920,889	531,258	3,711,702	54,762	62,850,506

Notes to the Consolidated Financial Statements

53. Interest rate risk associated with non-trading portfolios (cont.)

Financial liabilities	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Deposits from customers	41,734,119		15,378			41,749,497
Borrowings	748,130	3,647,174	9,314,837	1,347,186	75,926	15,133,254
Issued bills		1,979,218	1,955,539			3,934,757
Subordinated liabilities					1,058,741	1,058,741
Financial liabilities excluding derivatives	42,482,249	5,626,392	11,285,753	1,347,186	1,134,667	61,876,248
Effect of derivatives	3,901,598					3,901,598
Total	46,383,847	5,626,392	11,285,753	1,347,186	1,134,667	65,777,847
Total interest repricing gap	6,248,048	294,496	(10,754,495)	2,364,516	(1,079,905)	(2,927,340)

31.12.2016

Financial assets	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Cash and cash equivalents	11,643,171	389,709				12,032,879
Loans to customers	24,479,523	987,649	266,547	226,797	54,804	26,015,321
Financial assets excluding derivatives	36,122,694	1,377,358	266,547	226,797	54,804	38,048,200
Effect of derivatives	13,719,544	18,544	500,000	520,000		14,758,087
Total	49,842,237	1,395,902	766,547	746,797	54,804	52,806,287

Financial liabilities	Up to 1 month	1-3 months	3-12 months	1-5 years	Over 5 years	Total
Deposits from customers	32,459,684	4,398			14,851	32,478,933
Borrowings	858,746	7,861,950	4,778,090			13,498,785
Issued bills		1,975,136	1,947,782			3,922,918
Subordinated liabilities					572,385	572,385
Financial liabilities excluding derivatives	33,318,429	9,841,484	6,725,872	0	587,236	50,473,020
Effect of derivatives	1,528,157	500,000				2,028,157
Total	34,846,586	10,341,484	6,725,872	0	587,236	52,501,177
Total interest repricing gap	14,995,651	(8,945,582)	(5,959,324)	746,797	(532,432)	305,110

b. Sensitivity analysis

The Group performs monthly sensitivity analysis on financial assets and liabilities in non-trading portfolios subject to interest rate risk. The sensitivity analysis assumes a shift in the yield curves for all currencies. A parallel shift in yield curves would have the following impact on the Group's pre-tax profit and equity, assuming all other risk factors remain constant:

Currency	Shift in basis points	31.12.2017		31.12.2016	
		Downward	Upward	Downward	Upward
ISK, indexed	50	(30,256)	30,256	(2,987)	2,987
ISK, non-indexed	100	90,343	(90,343)	39,081	(39,081)
Other currencies	20	22	(22)	42	(42)
Total		60,109	(60,109)	36,137	(36,137)

Notes to the Consolidated Financial Statements

54. Exposure towards changes in the CPI

a. Definition

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

The Group is exposed to Icelandic inflation since CPI indexed assets exceed CPI indexed liabilities. All indexed assets and liabilities are valued according to the CPI measure at any given time and changes in CPI are recognised in the income statement as interest.

b. Management

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

c. Balance of CPI linked assets and liabilities

The net balance of CPI linked assets and liabilities is specified as follows:

	31.12.2017	31.12.2016
Assets	7,180,237	6,124,041
Liabilities	(5,927,047)	(4,882,993)
Total	1,253,191	1,241,048

d. Sensitivity to changes in CPI

Given the net balance of CPI linked assets and liabilities, a 1% change in the CPI would, with other things constant, result in the following changes to the Group's pre-tax profit.

	31.12.2017		31.12.2016	
	-1%	1%	-1%	1%
Government bonds	(2,295)	2,295	(9,783)	9,783
Other fixed income securities	(20,049)	20,049	(13,328)	13,328
Loans to customers	(24,459)	24,459	(27,930)	27,930
Derivatives	(25,000)	25,000	(10,200)	10,200
Short positions	2,784	(2,784)	3,200	(3,200)
Deposits	46,487	(46,487)	40,130	(40,130)
Subordinated debt	10,000	(10,000)	5,500	(5,500)
	(12,532)	12,532	(12,410)	12,410

The effect on equity would be the same.

55. Currency risk

a. Definition

Currency risk arises when financial instruments are not denominated in the functional currency of the respective Group entity and can affect both the Group's income statement and statement of financial position. A part of the Group's financial assets and liabilities is denominated in foreign currencies.

b. Management

Currency positions are monitored by risk management and reported to the ALCO committee. Any mismatch between assets and liabilities in each currency is monitored closely and managed within limits.

The Group is subject to limits set by the Central Bank of Iceland regarding the maximum open currency position. At 31 December 2017 and 31 December 2016 the Group's position in foreign currencies was within those limits.

c. Exchange rates

The following exchange rates have been used by the Group in the preparation of these financial statements:

	Closing	Average	Closing	Average
	31.12.2017	2017	31.12.2016	2016
EUR/ISK	125.1	120.5	119.1	133.6
USD/ISK	104.4	106.8	112.8	120.7

Notes to the Consolidated Financial Statements

55. Currency risk (cont.)

d. Breakdown of financial assets and financial liabilities denominated in foreign currencies

31.12.2017

Financial assets

	EUR	USD	GBP	NOK	Other currencies	Total
Cash and cash equivalents	1,490,412	7,222,010	755,602	154,130	1,023,763	10,645,918
Shares and other variable income securities	6	17	15,806		28	15,857
Loans to customers	2,401,215	167,266			171,349	2,739,830
Other assets	301,083	108,898	20,413	269	23,638	454,301
Financial assets excluding derivatives	4,192,716	7,498,192	791,821	154,400	1,218,779	13,855,907
Derivatives	375,150	209,183				584,333
Total	4,567,866	7,707,375	791,821	154,400	1,218,779	14,440,240

Financial liabilities

	EUR	USD	GBP	NOK	Other currencies	Total
Deposits from customers	3,390,665	7,694,264	737,308	117,500	861,476	12,801,213
Borrowings	37,737					37,737
Other liabilities	138,333	27,019	121,113	38,420	101,885	426,770
Financial liabilities excluding derivatives	3,566,735	7,721,283	858,421	155,920	963,361	13,265,720
Derivatives	500,200	60,290			152,544	713,034
Total	4,066,935	7,781,573	858,421	155,920	1,115,905	13,978,754

Net currency position

	EUR	USD	GBP	NOK	Other currencies	Total
Financial assets	4,567,866	7,707,375	791,821	154,400	1,218,779	14,440,240
Financial liabilities	(4,066,935)	(7,781,573)	(858,421)	(155,920)	(1,115,905)	(13,978,754)
Financial guarantee contracts	28,053	26,105				54,158
Total	528,984	(48,093)	(66,600)	(1,520)	102,874	515,644

31.12.2016

Financial assets

	EUR	USD	GBP	NOK	Other currencies	Total
Cash and cash equivalents	1,640,515	868,929	394,601	117,095	202,072	3,223,213
Shares and other variable income securities	1,887					1,887
Loans to customers	1,197,770	296,109			146,062	1,639,941
Other assets		22,925				22,925
Financial assets excluding derivatives	2,840,173	1,187,963	394,601	117,095	348,134	4,887,966
Derivatives	502,160	169,531				671,691
Total	3,342,333	1,357,494	394,601	117,095	348,134	5,559,657

Financial liabilities

	EUR	USD	GBP	NOK	Other currencies	Total
Deposits from customers	1,355,102	789,223	392,095	71,152	118,460	2,726,032
Borrowings	35,978					35,978
Other liabilities						0
Financial liabilities excluding derivatives	1,391,080	789,223	392,095	71,152	118,460	2,762,010
Derivatives	1,906,080	564,100			111,888	2,582,068
Total	3,297,160	1,353,323	392,095	71,152	230,348	5,344,078

Net currency position

	EUR	USD	GBP	NOK	Other currencies	Total
Financial assets	3,342,333	1,357,494	394,601	117,095	348,134	5,559,657
Financial liabilities	(3,297,160)	(1,353,323)	(392,095)	(71,152)	(230,348)	(5,344,078)
Financial guarantee contracts	32,165					32,165
Total	77,338	4,171	2,506	45,943	117,786	247,744

Notes to the Consolidated Financial Statements

55. Currency risk (cont.)

e. Sensitivity to currency risk

Given the net currency position, a 10% change in the value of the ISK would, with other things constant, result in the following changes to the Group's pre-tax profit.

Assets and liabilities denominated in foreign currencies	31.12.2017		31.12.2016	
	-10%	+10%	-10%	+10%
EUR	52,898	(52,898)	7,734	(7,734)
USD	(4,809)	4,809	417	(417)
GBP	(6,660)	6,660	251	(251)
NOK	(152)	152	4,594	(4,594)
Other currencies	10,287	(10,287)	11,779	(11,779)
Total	51,564	(51,564)	24,774	(24,774)

The effect on equity would be the same.

56. Other price risk

Other price risk arises from changes in the market prices of shares and other variable income securities in the Group's portfolio. The Group directly holds listed and unlisted shares and other variable income securities, while also gaining exposure to listed shares through portfolio options trading. The table below shows the Group's net exposure, including delta-adjusted options exposure.

	31.12.2017			31.12.2016		
	Average	Max	Exposure	Average	Max	Exposure
Listed shares	1,114,793	2,306,393	1,266,507	1,179,342	1,706,461	1,144,496
Unlisted shares	467,468	955,408	690,951	623,585	819,213	567,776
Unlisted unit shares	1,017,295	1,710,146	879,916	1,396,410	3,216,784	1,442,194
Total			2,837,375			3,154,466

57. Operational risk

a. Definition

Operational risk is the risk of financial losses resulting from the failure or inadequacy of internal processes or systems, from employee error or from external events. Operational risk includes legal risk, but excludes reputational risks. It is therefore inherent in all areas of business activities.

b. Management

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

Notes to the Consolidated Financial Statements

Financial assets and liabilities

58. Accounting classification of financial assets and liabilities

The accounting classification of financial assets and liabilities is specified as follows:

31.12.2017 Financial assets	Held for trading	Designated at fair value	Loans and receivables	Other at amortised cost	Total carrying amount
Cash and cash equivalents			19,985,823		19,985,823
Receivables from Central Bank			507,916		507,916
Fixed income securities	5,598,409				5,598,409
Shares and other variable income securities	2,833,752	3,623			2,837,375
Securities used for hedging	14,026,433				14,026,433
Loans to customers			25,338,250		25,338,250
Derivatives	1,052,652				1,052,652
Other assets			1,797,913		1,797,913
Total	23,511,246	3,623	47,629,902	0	71,144,771

Financial liabilities	Held for trading	Designated at fair value	Loans and receivables	Other at amortised cost	Total carrying amount
Deposits from customers				41,749,497	41,749,497
Borrowings				15,133,254	15,133,254
Issued bills				3,934,757	3,934,757
Subordinated liabilities				1,058,741	1,058,741
Short positions held for trading	370,163				370,163
Derivatives	364,692				364,692
Other liabilities				1,936,693	1,936,693
Total	734,855	0	0	63,812,941	64,547,796

31.12.2016 Financial assets	Held for trading	Designated at fair value	Loans and receivables	Other at amortised cost	Total carrying amount
Cash and cash equivalents			12,032,879		12,032,879
Receivables from Central Bank					0
Fixed income securities	3,945,778				3,945,778
Shares and other variable income securities	2,719,252	435,213			3,154,466
Securities used for hedging	12,389,392				12,389,392
Loans to customers			26,015,321		26,015,321
Derivatives	552,493				552,493
Other assets			967,954		967,954
Total	19,606,915	435,213	39,016,154	0	59,058,283

Financial liabilities	Held for trading	Designated at fair value	Loans and receivables	Other at amortised cost	Total carrying amount
Deposits from customers				32,478,933	32,478,933
Borrowings				13,498,785	13,498,785
Issued bills				3,922,918	3,922,918
Subordinated liabilities				572,385	572,385
Short positions held for trading	80,186				80,186
Derivatives	498,769				498,769
Other liabilities				1,101,679	1,101,679
Total	578,955	0	0	51,574,699	52,153,654

Notes to the Consolidated Financial Statements

59. Financial assets and liabilities measured at fair value

a. Fair value hierarchy

The fair value of financial assets and liabilities that are traded in active markets are based on quoted market prices. For other financial instruments the Bank determines fair value using various valuation techniques. IFRS 13 specifies a fair value hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources whereas unobservable inputs reflect the Bank's market assumptions. These two types of inputs result in the following fair value hierarchy:

- Level 1

Inputs are quoted market prices (unadjusted) in active markets for identical instruments.

- Level 2

Inputs are not quoted market prices but are observable either directly, i.e. as prices, or indirectly, i.e. derived from prices. This category includes financial instruments valued using quoted prices in active markets for similar instruments, quoted prices for similar or identical instruments in markets that are considered less than active and other instruments which are valued using techniques which rely primarily on inputs that are directly or indirectly observable from market data.

- Level 3

Inputs are not observable or unobservable inputs have a significant effect on the valuation. This category includes instruments that are valued based on quoted prices for similar instruments for which significant unobservable adjustments are required to reflect the differences between the instruments.

b. Valuation process

The Bank's ALCO committee is responsible for fair value measurements of financial assets and liabilities classified as level 2 or level 3 instruments. The valuation is carried out by personnel from Risk and Treasury and is revised at least quarterly, or when there are indications of significant changes in the underlying inputs.

c. Valuation techniques

The Group uses widely recognized valuation techniques, including net present value and discounted cash flow models, comparison with similar instruments for which market observable prices exist, Black-Scholes and other valuation models.

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

For more complex 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, and are derived from market prices or rates or are estimated based on assumptions. When entering into a transaction, the financial instrument is recognised initially at the transaction price, which is the best indicator of fair value, although the value obtained from the valuation model may differ from the transaction price. This initial difference, usually an increase in fair value, indicated by valuation techniques is recognised in income depending upon the individual facts and circumstances of each transaction and no later than when the market data becomes observable.

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

Notes to the Consolidated Financial Statements

59. Financial assets and liabilities measured at fair value (cont.)

d. Fair value hierarchy classification

The fair value of financial assets and liabilities measured at fair value in the statement of financial position is classified into the fair value hierarchy as follows:

31.12.2017

Financial assets	Level 1	Level 2	Level 3	Carrying amount
Held for trading				
Fixed income securities	5,296,556	301,852		5,598,409
Shares and other variable income securities	1,718,159	587,810	527,782	2,833,752
Securities used for hedging	14,003,674	22,760		14,026,433
Derivatives		1,052,652		1,052,652
Designated at fair value				
Shares and other variable income securities			3,623	3,623
Total	21,018,390	1,965,074	531,405	23,514,869
Financial liabilities				
Held for trading				
Short positions held for trading	370,163			370,163
Derivatives		364,692		364,692
Total	370,163	364,692	0	734,855

There were no transfers between levels during the year.

31.12.2016

Financial assets	Level 1	Level 2	Level 3	Carrying amount
Held for trading				
Fixed income securities	3,790,109	155,669		3,945,778
Shares and other variable income securities	2,076,963	505,292	136,997	2,719,252
Securities used for hedging	12,389,392			12,389,392
Derivatives		477,199	75,294	552,493
Designated at fair value				
Shares and other variable income securities		287	434,926	435,213
Total	18,256,464	1,138,447	647,218	20,042,129
Financial liabilities				
Held for trading				
Short positions held for trading	80,186			80,186
Derivatives		498,769		498,769
Total	80,186	498,769	0	578,955

There were no transfers between levels during the year.

Notes to the Consolidated Financial Statements

59. Financial assets and liabilities measured at fair value (cont.)

e. Reconciliation of changes in Level 3 fair value measurements

	Shares and other var. income		
	securities	Derivatives	Total
31.12.2017			
Balance as at 1 January 2017	571,924	75,294	647,218
Total gains and losses in profit or loss	32,479	(139,751)	(107,272)
Additions through a business combination	670		670
Purchases	587,238	64,457	651,695
Settlements	77,691	0	77,691
Sales	(738,596)	0	(738,596)
Balance as at 31 December 2017	531,405	0	531,405
	Shares and other var. income		
	securities	Derivatives	Total
31.12.2016			
Balance as at 1 January 2016	533,838	0	533,838
Total gains and losses in profit or loss	107,783		107,783
Purchases	481,094	75,294	556,388
Sales	(550,791)		(550,791)
Balance as at 31 December 2016	571,924	75,294	647,218

f. Change in unrealised gains or losses related to Level 3 financial assets held at year-end

	Shares and other var. income securities
Net financial income - 2017	
Financial assets designated at fair value through profit or loss	32,479
Total	32,479
Net financial income - 2016	
Financial assets designated at fair value through profit or loss	107,783
Total	107,783

g. Fair value measurements for Level 3 financial assets

Level 3 assets consist primarily of highly illiquid, unlisted bonds, shares and share certificates. Each asset is evaluated separately but assets within an asset group share a valuation method. The following valuation methods are in use in 2017:

Asset class	Method	Significant unobservable input	Range	Book value 31.12.2017
Unlisted shares	Market price	Recent trades	-	531,405
Unlisted unit shares	Investment multiplier	Original investment	0.00	0
Derivatives	Discounted cash flow	Equity	-	0
Total				531,405
Asset class	Method	Significant unobservable input	Range	Book value 31.12.2016
Unlisted shares	P/B multiplier	Equity	1.0-1.5	567,489
Unlisted unit shares	Investment multiplier	Original investment	0.05	4,434
Derivatives	Discounted cash flow	Equity	-	75,294
Total				647,218

Given the methods used, the possible range of the significant unobservable inputs is wide. When determining the values used the Group considers the financial strength of the entity in question, recent trades if any and multipliers for comparable instruments.

h. The effect of unobservable inputs in Level 3 fair value measurements

The Group believes its estimates represent appropriate approximations of fair value and that the use of different valuation methodologies and reasonable changes in assumptions or unobservable inputs would not significantly change the estimates.

A 10% change in the estimates would have the following effect on profit before taxes:

	+10%	-10%
Shares and other variable income securities	53,140	(53,140)
Total	53,140	(53,140)

Notes to the Consolidated Financial Statements

60. Financial assets and liabilities not measured at fair value

Financial assets and liabilities not measured at fair value have either a short time to maturity or settlement, variable interest rates or other attributes which result in the carrying amount being a reasonable approximation of their fair value.

Fair value hierarchy classification

The Group holds financial instruments which are not measured at fair value. Except for loans to customers, the Group believes that the best estimate of the fair value of these financial instruments is equal to the carrying amount at the reporting date and does therefore not report a fair value for these financial instruments. Loans to customers are classified as level 3, in the fair value hierarchy, and have a book value of ISK 25,338,250 thousand at end of December 2017. The estimated fair value of loans to customers at end of December 2017 is ISK 25,085,563 thousand.

Notes to the Consolidated Financial Statements

Segment information

61. Business segments

Segment reporting is based on the same principles and structure as internal reporting to senior management and the board of directors. Segment performance is evaluated on earnings before tax.

Reportable segments

The Group defines five reportable segments which reflect the reporting structure of the Bank.

- Corporate Banking
Corporate Banking offers various forms of banking services and related advisory services, in addition to providing specialized lending services.
- Corporate Finance
Corporate Finance provides its customers with impartial and independent advice concerning purchases, sales and mergers and acquisitions of companies.
- Capital Markets
Capital Markets offers securities and foreign currency brokerage, derivatives brokerage and forward contracts to clients, which include institutional investors, corporates and high net worth individuals.
- Proprietary Trading and Treasury
Proprietary Trading and Treasury provide market making services to its clients as well as providing the Bank with treasury services.
- Asset Management
Products and services offered include asset management, both domestic and foreign assets, private banking, and private pension plans.

Information about other divisions of the Bank, e.g. non-revenue generating divisions, is presented under the heading Support functions and eliminations.

	Corporate Banking	Corporate Finance	Capital Markets	Proprietary trading and Treasury	Asset Management	Support functions and eliminations	Total
2017							
Net interest income	1,410,974	(22)	151,067	(9,305)	10,623	(807)	1,562,530
Net fee and commission income	574,796	415,372	649,487	97,679	1,167,572	(92,760)	2,812,146
Net financial income	250,730	(3,712)	(13,351)	303,671	12,487	(2,590)	547,234
Share in profit of discontinued operations	8,403						8,403
Share in profit of associates	48,833	0	0	0	15,079	0	63,912
Other operating income	16,011	0	66	661	8,675	(10,408)	15,005
Net operating income	2,309,747	411,638	787,269	392,706	1,214,436	(106,565)	5,009,230
Salaries and related expenses	(189,552)	(197,610)	(308,837)	(163,675)	(577,107)	(959,446)	(2,396,227)
Other operating expenses	(346,162)	(81,869)	(80,582)	(39,974)	(209,051)	(515,822)	(1,273,460)
Impairment of loans and receivables	(14,228)					0	(14,228)
Revaluation on investment properties	92,258						92,258
Loss from assets held for sale	0						0
Profit (loss) before cost allocation and tax	1,852,064	132,158	397,851	189,057	428,278	(1,581,834)	1,417,573
Net segment revenue from external customers	1,594,593	411,638	1,353,319	541,810	1,214,436	(106,565)	5,009,230
Net segment revenue from other segments	715,154	0	(566,050)	(149,105)	0	0	0

Notes to the Consolidated Financial Statements

61. Business segments (cont.)

	Corporate Banking	Corporate Finance	Capital Markets	Proprietary trading and Treasury	Asset Management	Support functions and eliminations	Total
2016							
Net interest income	1,015,606	5,759	149,789	(109,857)	3,580	(597)	1,064,281
Net fee and commission income	494,249	288,834	839,063	81,973	1,204,196	(68,127)	2,840,188
Net financial income	361,432	0	2,225	910,423	8,610	0	1,282,690
Share in loss of discontinued operations	(13,488)						(13,488)
Share in profit of associates	148,985						148,985
Other operating income	(11,581)	4,887	1,964	100	3,870	(3,659)	(4,420)
Net operating income	1,995,202	299,481	993,040	882,639	1,220,256	(72,383)	5,318,236
Salaries and related expenses	(182,151)	(177,542)	(330,036)	(155,420)	(482,714)	(746,016)	(2,073,879)
Other operating expenses	(289,309)	(44,745)	(150,284)	(50,360)	(177,262)	(433,566)	(1,145,528)
Impairment of loans and receivables	(228,349)					2,000	(226,349)
Loss from assets held for sale	(3,395)						(3,395)
Profit (loss) before cost allocation and tax	1,291,998	77,194	512,720	676,858	560,280	(1,249,964)	1,869,086
Net segment revenue from external customers	1,514,525	299,481	1,569,855	786,501	1,220,256	(72,383)	5,318,236
Net segment revenue from other segments	480,677	0	(576,815)	96,138	0	0	0

Internal reporting is based on the results of the Bank, which accounts for around 91% (2016: 91%) of the net operating income of the Group, and do not take into account the effects of consolidation. As a result, elimination entries are needed to reconcile internal reporting with consolidated results. Elimination entries arise primarily from interest calculated on internal balances, share in the results of subsidiaries and fees charged for services the parent provides to subsidiaries.

Notes to the Consolidated Financial Statements

Other information

62. Operating lease commitments

The Group leases under operating leases office premises for its operations. In some leases the rent is based on the Icelandic Consumer Price Index and changes accordingly. Future non-cancellable minimum operating lease payments are specified as follows:

	31.12.2017	31.12.2016
Up to 1 year	91,745	83,525
1-5 years	328,839	229,199
Later than 5 years	204,016	289,525
Total	624,600	602,248

63. Pledged assets

The Group has pledged assets, in the ordinary course of banking business, to the Central Bank of Iceland to the amount of ISK 2,7 billion as at 31 December 2017 (2016: ISK 2,6 billion) to secure settlement in the Icelandic clearing systems. Further pledges have been placed in the ordinary course of banking business for netting and set-off arrangements in the total amount of ISK 0,6 billion as at 31 December 2017 (2016: ISK 0,5 billion).

64. Related parties

a. Definition of related parties

The Group has a related party relationship with the board members of the Bank, the CEO of the Bank and key employees (together referred to as management), associates as disclosed in note 23, shareholders with significant influence over the Bank (defined as holding 10% or greater of the shares in the Bank as disclosed in note 68), close family members of individuals identified as related parties and entities under the control or joint control of related parties.

b. Arm's length

Transactions with related parties are carried out at arm's length and subject to an annual review by the Bank's internal auditor.

c. Effects on statement of financial position

	Loans & receivables	Deposits & payables
31.12.2017		
Shareholders	0	50,427
Management	2,061	122,464
Associates	267,495	4,783,028
Total	269,556	4,955,918
	Loans & receivables	Deposits & payables
31.12.2016		
Shareholders	70	136,567
Management	15,066	720,184
Associates	416,056	63,536
Total	431,192	920,287

d. Off-balance sheet obligations

There were no off-balance sheet obligations with related parties during year.

d. Effects on income statement

	Interest income	Interest expense	Fees received	Fees paid
2017				
Shareholders	0	2,334	3,151	0
Management	239	2,892	268	3,506
Associates	0	11,814	278,989	0
Total	239	17,041	282,408	3,506
	Interest income	Interest expense	Fees received	Fees paid
2016				
Shareholders	15	5,972	16,463	18,530
Management	508	18,031	4,724	69,341
Associates	11,790	197	8,973	0
Total	12,312	24,200	30,160	87,871

Further information about salaries and benefits paid to the Board of Directors, the CEO and Managing Directors is provided in note 10.

Notes to the Consolidated Financial Statements

65. Remuneration policy

The Board of Directors has adopted a remuneration policy at the proposal of the Remuneration Committee. The policy was approved by the Bank's Annual General Meeting in March 2017.

The remuneration policy conforms to Article 57 of Act No. 161/2002 on Financial Undertakings, Act No. 2/1995 on Public Limited Companies and the Icelandic FSA's directive No. 388/2016 on Incentive Schemes. The policy covers three remuneration components, base pay, performance based incentive scheme and other benefits, including pension fund contributions. A more detailed description of the policy can be found on the Bank's website, www.kvika.is.

66. Incentive scheme

The Board of Directors has approved a performance based incentive scheme at the proposal of the Remuneration Committee. The scheme forms a part of the remuneration policy adopted by the Bank.

a. Description

The incentive scheme conforms to the Icelandic FSA's directive No. 388/2016 on Incentive Schemes. Payments according to the scheme are based on key performance indicators (KPIs) that reflect the goals of the Bank, the division and the employee. The basis for performance based pay reflects sound risk management and does not induce excessive risk taking. Performance based pay to individual employees shall not exceed 25% of their annual base salary and 40% of the performance based pay shall be deferred for three years. Performance based pay that does not exceed 10% of annual base salary is not subject to deferral. Performance based pay can be in the form of cash payments or share options. Share based payments are discussed in note 67.

b. Performance based payments

	2017	2016
	Cash	Cash
Non-deferred	6,210	0
Deferred	4,140	(10,846)
Total	10,350	(10,846)

c. On-balance sheet deferred performance based payments

	31.12.2017	31.12.2016
Deferred cash payments	9,674	38,957
Deferred cash payments, acquired via merger	41,087	31,570
Total	50,761	70,527

67. Share-based payments

The remuneration policy approved by the Board of Directors of the Bank includes a share-based incentive scheme. The Board of Directors is authorised to increase the share capital of the Bank, in accordance with the Articles of Association, to fulfil any obligations arising from the scheme.

a. Description

In 2017 the Bank settled in cash stock options which were issued in 2012. The exercise price was 5.37 per share, the nominal amount was 16,251,274 shares and market price amounted to 6.5 per share. The cost to cash settle the options for the Bank amounted to 14 million.

In 2017 the Bank set up a new stock options plan. This plan is structured with the conditions set out in article 10 in law 90/2003 on income tax in mind. The average weighted exercise price is equal to 5.58 per share with a per annum increase of 5%. The options were issued to most employees, taking into consideration the conditions set out the Bank's remuneration policy, and the total nominal amount issued amounts to 8,543,799 shares. The options do not allow for cash settlement and vest evenly over 36 months following signing. The options are conditional on the employee remaining employed by the Bank and various other conditions which meet demands set by the Financial Supervisory Authority.

b. Movements in the number of stock options outstanding and their related weighted average exercise prices

The grant date fair value of the options granted through the scheme was as follows:

	Average exercise price per share	Stock options (thousands)
At 1 January 2016	0.00	16,251
Granted in 2016	0.00	0
Exercised	0.00	0
Forfeited in 2016	0.00	0
At 31 December 2016	0.00	16,251
Granted in 2017	5.58	8,544
Exercised	5.37	16,251
Forfeited in 2017	0.00	0
At 31 December 2017	0.00	8,544
Exercisable stock options at 31 December 2017	0.00	0

Notes to the Consolidated Financial Statements

68. Shareholders of the Bank

Ownership in the Bank is specified as follows:

Shareholder	Country	31.12.2017	31.12.2016	Beneficial owners
		%	%	
Vátryggingafélag Íslands hf.	Iceland	23.57%	-	
RES II ehf.	Iceland	9.32%	-	Sigurður Bollason (70%), Gunnar H. Gunnarsson (30%)
Lífeyrissjóður verzlunarmanna	Iceland	8.96%	9.53%	
K2B fjárfestingar ehf.	Iceland	7.52%	8.00%	Svanhildur Nanna Vigfúsdóttir (100%)
Mízar ehf.	Iceland	6.20%	6.60%	Guðmundur Steinar Jónsson (100%)
Brimgarðar ehf.	Iceland	4.74%	8.31%	Eggert Árni Gíslason (25%), Halldór Páll Gíslason (25%), Guðný Edda Gísladóttir (25%), Gunnar Þór Gíslason (25%)
Feier ehf.	Iceland	3.14%	-	Hjörleifur Þór Jakobsson (50%), Hjördís Ásberg (50%)
Sindrandi ehf.	Iceland	2.52%	-	Bogi Þór Siguroddsson (50%), Linda Björk Ólafsdóttir (50%)
Lífsverk lífeyrissjóður	Iceland	2.19%	-	
P 126 ehf.	Iceland	2.17%	1.20%	Einar Sveinsson (100%)
Breiðahvarf ehf.	Iceland	1.93%	-	Sigurður Sigurgeirsson (100%)
Alkor ehf.	Iceland	1.82%	1.94%	Berglind Björk Jónsdóttir (100%)
RPF ehf.	Iceland	1.36%	-	Gunnar Sverrir Harðarson (50%), Þórarinn Arnar Sævarsson (50%)
Eignarhaldsfélagið VGJ ehf.	Iceland	1.29%	-	Eiríkur Vignisson (90%), Sigríður Eiríksdóttir (10%)
Q44 ehf.	Iceland	1.25%	-	Magnús Kristinsson (100%)
Miðeind ehf.	Iceland	1.17%	-	Vilhjálmur Þorsteinsson (100%)
Stekkur fjárfestingarfélag ehf.	Iceland	1.14%	1.20%	Kristinn Aðalsteinsson (100%)
Eiríks ehf.	Iceland	1.09%	1.80%	Stefán Eiríks Stefánsson (100%)
Others, each less than 1%		18.07%	59.43%	2017: 100, 2016: 28
		99.45%	98.02%	
Treasury shares		0.55%	1.98%	
Issued share capital		100.00%	100.00%	

Beneficial owners are defined as owners holding a share of 10% or greater, directly or indirectly. The information presented is, among other things, based on publicly available information.

69. Other matters

Legal proceedings

When the Bank made an offer to acquire all the share capital of Virðing in the year 2017 it was aware of two law suits which Virðing was party to. When the two companies merged the Bank assumed Virðing's involvement as a party to the legal proceedings and any liabilities that might arise because of them. A part of the purchase price, ISK 300 million, was deposited into an escrow account to be used to offset possible damages resulting from the two law suits. These funds will be paid to the former owners of Virðing pending the outcome of these law suits. Should the Bank, as a result of these law suits, have to pay damages then the first ISK 300 million will be paid using the funds in the escrow account, but any damages in excess of that amount will be at the expense of the Bank.

The trustee of a bankrupt estate of a former client of Virðing (now the Bank) has filed a suit against the company with a subpoena which was brought to the courts on 25 September 2014. In the matter the bankrupt estate seeks to rescind payments that the bankrupt client made to Virðing and has made a claim for damages of ISK 287 million plus interest. The payments were made based on an agreement from 2010 for final settlement of the client's liabilities towards Virðing. Virðing (now the Bank) has claimed an acquittal in the matter, on the grounds that the legal requirements to rescind the measures of the bankrupt client have not been met, especially with regards to the insolvency of the bankrupt client, in addition to the fact that the trustee of the bankrupt estate himself confirmed the agreement for final settlement in the spring of 2014 and has therefore forfeited the bankrupt estate's right to the law suit. In addition to the aforementioned, standard time limits for rescission in accordance with the act on bankruptcy had lapsed with respect to the timing of the subpoena. Should the claims made by the bankrupt estate be confirmed, Kvika would have to pay the bankrupt estate damages but would instead be able to file its original claim against the bankrupt client plus penalty interest. That amount is higher than the claim made by the bankrupt estate, however the value of the estate's net assets is not clear at the moment. It is anticipated that the matter will be heard before the courts on 22 February 2018.

Virðing (now the Bank) was sued for damages with a subpoena which was brought to the courts on 1 November 2016. The main claim in the suit is a payment of ISK 301 million plus interest while the reserve claim is that the courts recognise that the Bank is liable to pay damages. The matter involves an alleged insufficient advice by Auður Capital hf. (which later merged with Virðing) in relation to the plaintiff's investment as a co-investor in a fund which is managed by Virðing (now the Bank). The District Court of Reykjavik ruled in the case on 24 January 2018 and acquitted the Bank of the plaintiff's claims and awarded the Bank ISK 3 million in legal costs. It is not clear at the moment whether the matter will be appealed to the National Court (Icelandic: Landsréttur) by the plaintiff.

Intended listing on the First North market

The Board of Directors of the Bank has decided to commence work on listing the Bank's shares on the First North market. The listing is anticipated to take place in the first half of 2018.

70. Events after the reporting date

On a meeting of shareholders on 18 January 2018 a resolution was passed on merging the class B share capital with the class A share capital of the Bank, and amending the Articles of Association accordingly.

There are no other material events after the reporting date.

Notes to the Consolidated Financial Statements

Significant accounting policies

71. Basis of consolidation

The accounting policies set out below have been applied consistently to all periods presented in these Consolidated Financial Statements, and have been applied consistently by Group entities.

a. Subsidiaries

Subsidiaries are entities controlled by the Group. Control exists when the Group is exposed to, 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 reassesses its relationship with an entity when there is a change in one or more of the elements of control.

The Group uses the acquisition method to account for the acquisition of subsidiaries. The cost of an acquisition is measured as the fair value, at the date of exchange, of the assets given, liabilities incurred or assumed and equity instruments issued. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any minority interest.

The excess of the cost of acquisition over the fair value of the Group's share of the identifiable net assets acquired is recognised as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised immediately in the income statement.

b. Non-controlling interest

Non-controlling interest represent the portion of profit or loss and equity not owned, directly or indirectly, by the Bank. Non-controlling interest is presented separately in the income statement and is included in equity in the statement of financial position, separately from equity attributable to owners of the Bank.

The Group chooses on an acquisition-by-acquisition basis whether to measure non-controlling interest in an acquiree at fair value or according to the proportion of non-controlling interests in the acquiree's net assets. Changes in the Bank's ownership interest in a subsidiary that do not result in a loss of control are accounted for as equity transactions. In such circumstances the carrying amounts of the controlling and non-controlling interests are adjusted to reflect the changes in their relative interests in the subsidiary. Any difference between the amount by which the non-controlling interest is adjusted and the fair value of the consideration paid or received is recognised directly in equity and attributed to the owners of the Bank.

c. Fiduciary services

The Group provides custody services, fund management and discretionary and advisory investment management services which require the Group to make decisions on the handling, acquisition or disposal of financial instruments on behalf of its clients.

The financial statements of managed funds and investment portfolios managed by the Group on behalf of customers are not included in the financial statements, as they do not constitute assets or liabilities of the Group.

d. Transactions eliminated on consolidation

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

e. Structured entities

Structured entities are entities that have been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The Group acts as investment manager or investment advisor, for example, to a number of investment funds operated by the fund management companies Júpíter rekstrarfélag hf. and Rekstrarfélag Virðingar hf. The purpose of these fund management companies is to generate fees from managing assets on behalf of third-party investors by providing investment strategies. These investment funds are financed through the issue of units to investors. The Group has no contractual obligation to provide financial support to these structured entities.

From time to time, the Group makes seed capital investments in certain fund products in order to establish track records for new products, to test new investment strategies or to launch new products at a viable minimum size.

The Group has set up a formal procedure to assess whether or not to consolidate investment funds managed and administered by the Group on behalf of its customers and other investors in the consolidated financial statements. As part of this assessment, the Group reviews all facts and circumstances including the purpose and design of the investment fund, to determine whether the Group, as fund manager, is acting as agent or principal. The Group is deemed to be a principal when the Group acts as fund manager and cannot be removed without cause, has variable returns through significant holdings and is able to influence the returns of the funds by exercising its power.

Notes to the Consolidated Financial Statements

72. Foreign currency

a. Foreign currency transactions

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

Foreign currency differences are posted as a separate line item under net financial income as disclosed in notes 6 and 83.

b. Foreign operations

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

Translation differences on foreign operations are presented as a separate category in the statement of changes in equity.

73. Recognition and derecognition of financial assets and liabilities

a. Recognition

Loans to customers and deposits are recognised on the date that they are originated. All other financial assets and liabilities are initially recognised on the trade date, which is the date when the Group becomes a party to the contractual provisions of the instrument.

b. Derecognition

A financial asset is derecognised when the contractual rights to the cash flows from the asset expire, or when the Group enters into a transaction in which substantially all the risks and rewards of ownership of the financial asset are transferred. Any interest in transferred financial assets that is created or retained by the Group is recognised as a separate asset or liability.

Financial liabilities are derecognised when the obligation of the Group is discharged, cancelled or expires.

74. Offsetting

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

Income and expenses are presented on a net basis for gains and losses arising from a group of similar transactions, such as in the Group's trading activity, or other circumstances permitted by International Financial Reporting Standards.

75. Amortised cost measurement of financial assets and liabilities

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

76. 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 payment when due in accordance with the terms of a debt instrument.

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

Notes to the Consolidated Financial Statements

77. Financial instruments - accounting classification

Upon initial recognition, financial assets and liabilities are classified into one of the categories below. This classification determines amongst other things initial measurement, subsequent accounting and handling of interest revenue and expenses. International Financial Reporting Standards restrict the reclassification of financial instruments after initial recognition.

a. Held for trading

A financial instrument is classified as held for trading if it is purchased or incurred with the intention to resell and repurchase within a short period of time, or if it is a part of a group of defined financial instruments managed on a portfolio basis and historical data shows recent pattern of short-term profit taking or it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Financial assets held for trading include fixed income securities, shares and other variable income securities and derivatives and securities used for hedging. Financial liabilities held for trading include derivatives and short positions, i.e. commitments to deliver financial assets that the Bank has borrowed and sold to a third party.

Financial instruments held for trading are initially recognised at fair value, with transactions costs recognised in profit or loss. They are subsequently measured at fair value in the statement of financial position. Interest income and expense from derivatives is recognised in net interest income but all other interest income and expense, and all changes in fair value, are recognised as financial income.

b. Designated at fair value

A financial instrument is designated at fair value through profit and loss when it is a part of a portfolio of financial instruments that are managed on the basis of fair value and information provided to management is based on fair value.

Financial assets designated at fair value include fixed income securities and shares and other variable income securities.

Financial instruments designated at fair value are initially recognised at fair value, with transactions costs recognised in profit or loss. They are subsequently measured at fair value in the statement of financial position. Interest income and expense, and all changes in fair value, are recognised as financial income.

c. Loans and receivables

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market are classified as loans and receivables.

Financial assets classified as loans and receivables include cash and cash equivalents, loans to customers and receivables.

Financial assets classified as loans and receivables are initially recognised at fair value, which is typically equal to cost, i.e. cash advanced plus any transaction costs. They are subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing assets, is included in the carrying amount. Interest income is recognised in net interest income.

d. Other at amortised cost

Non-derivative financial liabilities with fixed or determinable payments that are not quoted in an active market are classified as other at amortised cost.

Financial liabilities classified as other at amortised cost include deposits, borrowings, bonds, bills and payables.

Financial liabilities classified as other at amortised cost are initially recognised at fair value, which is typically equal to cost, i.e. cash advanced less any transaction costs. They are subsequently measured at amortised cost using the effective interest method. Accrued interest, in the case of interest bearing liabilities is included in the carrying amount. Interest expense is recognised in net interest income.

Notes to the Consolidated Financial Statements

78. Determination of fair value

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 in the principal or, in its absence, the most advantageous market to which the Group has access at that date. The fair value of a liability reflects its non-performance risk. When available, the Group measures the fair value of an instrument using the quoted price in an active market for that instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

If there is no quoted price in an active market, then the Group uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs. The chosen valuation technique incorporates all of the factors that market participants would take into account in pricing a transaction. For further information on valuation techniques, refer to notes 59 - 60.

The best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received. If the Group determines that the fair value at initial recognition differs from the transaction price and the fair value is evidenced neither by a quoted price in an active market for an identical asset or liability nor based on a valuation technique that uses only data from observable markets, then the financial instrument is initially measured at fair value, adjusted to defer the difference between the fair value at initial recognition and the transaction price. Subsequently, that difference is recognised in profit or loss on an appropriate basis over the life of the instrument but no later than when the valuation is wholly supported by observable market data or the transaction is closed out.

79. Impairment

a. General principle

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

b. Reversal of impairment

If, in a subsequent period, the amount of an impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is recognised as reduction of cost in the income statement. An impairment loss recognised for goodwill is not reversed in a subsequent period.

c. Calculation of recoverable amount

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

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

80. Impairment of loans

a. Indications of impairment

Objective evidence of impairment includes information about one or more of the following:

- Indications of significant financial difficulties of the borrower, including financial restructuring and refinancing concessions that a lender would not otherwise consider
- A breach of contract, such as a default on instalments or on interest or principal payments
- An observable decrease in the estimated future cash flows from a group of loans due to adverse changes in the economic conditions of a sector or region in which the borrower operates, even if the decrease cannot yet be identified with the individual financial assets in the group
- The disappearance of an active market for an asset held as collateral

Impairment losses expected as a result of events taking place after the reporting date, no matter how likely, are not recognised.

b. Calculation of impairment losses

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

c. Individually assessed loans

Impairment losses on individually assessed loans are determined by an evaluation of the exposures on a case-by-case basis. This procedure is applied to all loans that are considered individually significant. In making the assessment, the following factors are considered:

- The Group's aggregate exposure towards the customer
- The amount and timing of expected receipts and recoveries
- The likely recovery upon liquidation or bankruptcy
- Complexity and uncertainty related to ranking of creditor claims and legal standing
- The realisable value of securities or other credit mitigants and the likelihood of successful repossession
- The likely deduction of any costs involved in recovery of amounts outstanding

Notes to the Consolidated Financial Statements

80. Impairment of loans (cont.)

d. Collectively assessed loans

Impairment losses on collectively assessed loans are determined by an evaluation of the exposures on a group of loans with similar risk characteristics. This procedure is applied to all loans that are not considered individually significant, or have been individually assessed but showed no indications of impairment. This loss covers loans that are impaired at the reporting date but which will not be individually identified as such until some time in the future.

The collective impairment loss is determined after taking into account the following:

- Historical loss experience in portfolios of similar risk characteristics, for example, by industry sector, loan grade or product
- The estimated period between a loss occurring and that loss being identified and evidenced by the establishment of an allowance against the loss on an individual loan
- Management's judgement as to whether the current economic and credit conditions are such that the actual level of inherent losses is likely to be greater or less than that suggested by historical experience

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

e. Loan write-offs

The carrying amount of impaired loans is reduced through the use of an allowance account. Loans are written off, partially or in full, when there is no realistic prospect of recovery.

f. Forbearance

The Group may modify the contractual terms of a loan for a variety of reasons. Changes in terms are subject to the same policies and limits as new loans and are evaluated on a case by case basis. If the change is triggered by the borrower's inability to meet the terms and conditions of the loan (a forbearance activity), the loan is first evaluated for indications of impairment. If there is evidence of impairment the loan is subject to specific impairment and classified as such. If there is no identified need for specific impairment the loan is considered performing.

81. Interest income and expense

Interest income and expense are recognised in the income statement using the effective interest method. The effective interest rate is the rate that exactly discounts estimated future cash flows to the carrying amount of the financial asset or liability, over the expected life of the financial instrument. Estimated future cash flows take into account all contractual terms of the financial instruments but not future credit losses.

Interest income and expense presented in the income statement includes interest on:

- financial assets classified as loans and receivables
- financial assets classified as available for sale
- financial liabilities carried at amortised cost
- derivatives

Further information about the accounting classification of financial assets and liabilities is provided in notes 58 and 77.

82. Fee and commission income and expense

The Group earns income from providing various services to its customers. This includes fees for managing assets on behalf of customers, commissions received for equity and bond transactions and fees and commissions for various other financial services.

Fee and commission income and expense comprises the following:

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

83. Net financial income

Net financial income comprises the following:

- Realised and unrealised gains or losses from price changes of fixed income securities carried at fair value
- Realised and unrealised gains or losses from price changes of variable income securities
- Interest income from fixed income securities carried at fair value through profit or loss
- Dividends, excluding dividends from associates
- Fair value changes in derivatives
- Foreign exchange difference

84. Dividend income

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

Notes to the Consolidated Financial Statements

85. Administrative expenses

Administrative expenses comprise expenses other than interest expenses, fee and commission expenses and expenses related to fair value changes. A breakdown of administrative expenses is provided in note 8.

86. Employee benefits

a. Short-term employee benefits

Short-term employee benefits obligations are measured on an undiscounted basis and are expensed as the related service is provided. A liability is recognised for the amount expected to be paid under short-term cash bonus or profit-sharing 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.

b. Defined contribution plans

Obligations for contributions to defined contribution plans are expensed in profit or loss as the related service is provided. The Group has no further obligations once those contributions have been paid.

c. Share-based payments

Equity-settled share-based payments to employees are measured at the fair value of the equity instruments at grant date. The grant date fair value of equity-settled share-based payment awards granted to employees is recognised as an employee expense, with a corresponding increase in equity, over the period that the employees become unconditionally entitled to the awards. The amount recognised as an expense is adjusted to reflect the number of awards for which the related service and non-market performance conditions are expected to be met, such that the amount ultimately recognised as an expense is based on the number of awards that meet the related service and non-market performance conditions at the vesting date.

87. Income tax

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

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

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

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

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

88. Cash and cash equivalents

Cash and cash equivalents include notes and coins on hand, balances held with central banks and other financial institutions, and highly liquid financial assets with original maturities of three months or less from the acquisition date that are subject to an insignificant risk of changes in their fair value, and are used by the Group in the management of its short-term commitments.

Cash and cash equivalents are carried at amortised cost in the statement of financial position.

89. Fixed income securities

Fixed income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 77.

90. Shares and other variable income securities

Shares and other variable income securities consist of equity investments and unit shares in mutual funds. Shares and other variable income securities are initially measured at fair value and subsequently accounted for depending on their classification as discussed in note 77.

91. Securities used for hedging

Securities used for hedging consist of non-derivative financial assets that are used to hedge the Group's exposure arising from derivative contracts with customers. Securities used for hedging are measured at fair value as discussed in note 77.

Notes to the Consolidated Financial Statements

92. Loans to customers

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

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

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 at a future date ("reverse repo" or "stock borrowing"), the arrangement is accounted for as a loan and the underlying asset is not recognised in the Group's statement of financial position.

93. Derivatives

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

- Its value changes due to changes in an underlying variable, such as bond price, share price, security or price index (including CPI), foreign currency exchange rate or interest rate
- The contract requires no initial investment or an initial investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
- Settlement takes place at a future date

The Group uses derivatives for trading purposes and to hedge its exposure to market price risk, foreign exchange risk and inflation and interest risk arising from operating, financing and investing activities. The Group does not apply hedge accounting.

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

94. Investment properties

Investment properties is an asset which is specified for leasing to third parties, for returns or for both purposes. Investment properties are initially recognised at cost, later on, on fair value. Changes in fair values are recognised as gains or loss in the income statement. All gains are unrealised.

95. Intangible assets

a. Asset categories

The Group groups intangible assets into three categories:

- Software
Software comprise acquired software licences and external costs associated with the development of bespoke applications.
- Goodwill
Goodwill arises in business combinations. It is recognised as of the acquisition date and measured as the aggregate of (a) the fair value of the consideration transferred, (b) the recognised amount of any non-controlling interest in the acquiree, and (c) the fair value of any previously held equity interest in the acquiree, less the net recognised amount (generally fair value) of the identifiable assets acquired and liabilities assumed, all measured as at the acquisition date. The consideration transferred includes the fair value of assets transferred, liabilities incurred and equity interests issued by the Group. In addition, consideration transferred includes the fair value of any contingent consideration. Following initial recognition, goodwill is recognised at cost less any accumulated impairment losses.
- Other intangible assets
Other intangible assets comprise licences and acquired trademarks used in the operation of the Group.

The Group has not defined any internally generated intangible assets.

b. Initial recognition

Intangible assets are initially recognised at cost.

c. Subsequent measurement

The Group uses the cost model for measurement after recognition and intangible assets are carried at cost less any accumulated amortisation and any accumulated impairment losses. Intangible assets are reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable. An impairment loss is recognised in accordance with the accounting policy for non-financial assets described in note 80.

d. Amortisation

Intangible assets with finite useful life are amortised using the straight-line method over their estimated useful economic life, with the amortisation recognised in the income statement. The estimated useful life of intangible assets is as follows:

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

Depreciation of property and equipment and amortisation of intangible assets are presented together as a separate line item in administrative expenses as disclosed in note 8. Further breakdown is provided in notes 26-27.

Notes to the Consolidated Financial Statements

96. Property and equipment

a. Asset categories

The Group groups tangible assets into two categories:

- Real estate, which includes office and residential buildings, land and building rights
- Other property and equipment, which includes automobiles, furniture and fixtures, computers and other office equipment

b. Initial recognition

Property and equipment is initially recognised at cost, which includes direct expenses related to the purchase.

c. Subsequent measurement

The Group uses the cost model for the measurement after recognition and property and equipment is carried at cost less any accumulated depreciation and any accumulated impairment losses. Property and equipment is reviewed for indications of impairment or changes in estimated future economic benefits at each reporting date. If such indications exist, the assets are analysed to assess whether their carrying amount is fully recoverable. An impairment loss is recognized in accordance with the accounting policy for non-financial assets described in note 80.

d. Subsequent cost

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 property and equipment, is based on whether an identified component, or part of such component, has been replaced or not, or if the nature of the subsequent cost means a contribution of a new component. All other costs are expensed in the income statement when incurred.

e. Depreciation

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

Real estate	15-50 years
Other property and equipment	3-5 years

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

Depreciation of property and equipment and amortisation of intangible assets are presented together as a separate line item in administrative expenses as disclosed in note 8. Further breakdown is provided in notes 26-27.

97. Investments in associates

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

The Group's share of the total recognised gains and losses of associates is included in the financial statements of the Group on an equity accounted basis, from the date the significant influence commences until the date it ceases.

If the Group's share of loss exceeds its interest in an associate, the Group's carrying amount is reduced to zero 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 those profits only after its share of the profits equals the share of losses not recognised.

98. Other assets

Other assets are measured at amortised cost.

99. Assets classified as held for sale

Non-current assets that are expected to be recovered primarily through sale rather than through continuing use, are classified as held for sale. Immediately before classification as held for sale, the assets are remeasured in accordance with the Group's accounting policies. Thereafter the assets are measured at the lower of their carrying amount and fair value less cost to sell. Impairment losses on initial classification as held for sale and subsequent gains or losses on remeasurement are recognised in profit or loss. Gains are not recognised in excess of any cumulative impairment loss.

100. Deposits from customers

Deposits consist of time deposits and demand deposits. Money market deposits are included in borrowings. Deposits are recognised at amortised cost, including accrued interest.

Notes to the Consolidated Financial Statements

101. Borrowings

Borrowings are mostly comprised of money market deposits and issued bonds. They are initially recognised at fair value less attributable transaction costs. Subsequently, they are measured at amortised cost using the effective interest method. Accrued interest is included in their carrying amount.

When the Group sells a financial asset and simultaneously enters into an agreement to repurchase the asset, or a substantially similar asset, at a fixed price at a future date ("repo" or "stock lending"), the arrangement is accounted for as a borrowing and the underlying asset continues to be recognised in the Group's statement of financial position.

102. Issued bills

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

103. Subordinated liabilities

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

104. Short positions held for trading

Short positions are obligations of the Group to deliver financial assets borrowed by the Group and sold to third parties. Short positions are carried at fair value with all fair value changes recognised in the income statement under net financial income.

105. Short positions used for hedging

Short positions are obligations of the Group to deliver financial assets borrowed by the Group and sold to third parties. Short positions used for hedging consist of non-derivative financial liabilities that are used to hedge the Group's risk exposure arising from derivative contracts with customers.

106. Other liabilities

Other liabilities are measured at amortised cost.

107. Share capital

a. Treasury shares

Acquired own shares and other equity instruments (treasury shares) are deducted from equity. No gain or loss is recognised in income statement on the purchase, sale, issue or cancellation of treasury shares. Consideration paid or received is recognised directly in equity. Incremental transaction costs of treasury share transactions are accounted for as a deduction from equity, net of any related income tax benefit.

b. Share premium

Share premium represents excess of payment above nominal value (ISK 1 per share) that shareholders have paid for shares sold by the Group.

c. Dividends on share capital

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

108. Nature and purpose of equity reserves

a. Option reserve

The option reserve represents the cumulative charge to the income statement for options to purchase shares in the Bank granted under the Bank's Remuneration policy, which is discussed in notes 65-67.

b. Warrants reserve

The warrants reserve represents the consideration received for outstanding warrants, as disclosed in note 38.

c. Deficit reduction reserve

The deficit reduction reserve was created as a part of a share capital reduction approved by the Bank's Annual General Meeting in April 2014. The reserve has no specified purpose and can only be used with the approval of a shareholders' meeting.

d. Translation reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations, until the operations are sold, dissolved or abandoned.

Notes to the Consolidated Financial Statements

108. Nature and purpose of equity reserves (cont.)

- e. Restricted retained earnings
According to the Financial Statements Act No. 3/2006 the difference between share of profit of subsidiary or associate in excess of dividend payment or dividend payment pending, shall be transferred to a restricted retained earnings reserve, net of tax, which is not subject to dividend payments. When shareholding in subsidiary or associate is sold or written off the restricted retained earnings reserve shall be released and the amount transferred to retained earnings.
- f. Accumulated deficit - retained earnings
Accumulated deficit (retained earnings if positive) consists of undistributed profits and losses accumulated, less transfers to other reserves.

109. New standards and interpretations

The Group has adopted amendments to existing standards which became effective for the first time in 2017. The amendments did not have a material effect on these financial statements.

A number of new standards, amendments to standards and interpretations were not yet effective for the year ended 31 December 2017 and have not been applied in the preparation of these financial statements. Early adoption of new standards and amendments is not planned. Following is a summary of the new standards which are likely to affect the Group's Consolidated Financial Statements.

IFRS 9 Financial Instruments, which will become effective for annual reporting periods beginning on or after 1 January 2018. The new standard introduces extensive changes to previous guidance on the classification and measurement of financial instruments and introduces a new expected credit loss model for calculating impairment on financial assets. IFRS 9 requires that an entity's business model and a financial instrument's contractual cash flows will determine its classification and measurement in the financial statements. Upon initial recognition each financial asset will be classified as either Fair Value Through Profit or Loss ("FVTPL"), amortized cost, or Fair Value Through Other Comprehensive Income ("FVTOCI"). As the requirements under IFRS 9 are different than the assessments under the existing IAS 39 rules, some differences to the classification and measurement of financial assets under IAS 39 are expected. The classification and measurement of financial liabilities remain largely unchanged under IFRS 9 from current requirements. The Group is currently assessing the impact of the new standard on its financial statements.

IFRS 15 Revenue from Contracts with Customers, which will become effective for annual reporting periods beginning on or after 1 January 2018. It establishes a comprehensive framework for those factors which need to be taken into consideration in determining how revenue is recognised and will be applicable to all contracts with customers. However, interest and fee income integral to financial instruments and leases will continue to fall outside the scope of IFRS 15 and will be regulated by the other applicable standards. The standard specifies a comprehensive set of disclosure requirements. The Group is currently evaluating its impacts on its Financial Statements.

IFRS 16 Leases, which will become effective for annual reporting periods beginning on or after 1 January 2019, establishes a comprehensive framework for lease agreements. The Group is currently assessing the impact of the new standard.

110. Use of estimates and judgements

In the process of applying the Group's accounting policies, management makes use of judgements and estimates which are based on various assumptions. These judgements and estimates can affect the reported amounts of assets and liabilities, income and expense.

Assumptions and estimates are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances, and are reviewed on an on-going basis. The estimates form the basis for judgements about the carrying value of assets and liabilities that are not readily available from other sources and actual results may differ. Judgement may also be required in circumstances not involving estimates, e.g. when determining the substance of a particular transaction, contract or relationship.

The areas where the use of judgements and estimates has the most significant effect on the amounts recognised in the statement of financial position or the income statement are disclosed in this note.

- a. Fair value of financial instruments
The fair value of financial instruments that are not quoted in active markets is determined using valuation techniques which are reviewed regularly as discussed in note 59.
- b. Impairment of financial assets
As outlined in notes 79-80, the use of estimates and judgement is an important component of the calculation of impairment losses. 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. Unforeseen events could, however, result in further impairment losses which would have a material effect on the income statement and statement of financial position.
- c. Impairment of intangible assets
The Group has goodwill on its balance sheet as a result of the its acquisitions of Virðing hf. and Alda sjóðir hf. during 2017. Intangible assets with indefinite lifetime are subjected to impairment testing at least annually. The acquisition price of the recently acquired entity was based on estimated future cash flow that was expected to be incurred after the acquisition. No material changes have been on assumption used at the acquisition and therefore it is management's opinion that there is no indication of impairment.
- d. Deferred tax assets
Judgement is required to determine the extent to which deferred tax assets are recognised in the statement of financial position, based on the likely timing and level of future taxable profits.